No. 12,506

IN THE

United States Court of Appeals

For the Ninth Circuit

THE WESTERN PACIFIC RAILROAD CORPORATION and ALEXIS I. DUP. BAYARD, Receiver,
Plaintiffs and Appellants,

and

MEREDITH H. METZGER, HENRY OFFERMAN and J. S. FARLEE & CO., INC., a corporation,
Interveners and Appellants,

vs.

THE WESTERN PACIFIC RAILROAD COMPANY, et al.,
Defendants and Appellees.

Brief for Appellees

ALLAN P. MATTHEW,
JAMES D. ADAMS,
ROBERT L. LIPMAN,
BURNHAM ENERSEN,
WALKER LOWRY,
McCUTCHEN, THOMAS, MATTHEW, GRIFFITHS & GREENE,
1500 Balfour Building,
San Francisco 4, California
Attorneys for The Western Pacific Railroad Company, et al., Appellees;

EVERETT A. MATHEWS,
PILLSBURY, MADISON & SUTRO,
225 Bush Street,
San Francisco 4, California

A. DONALD MACKINNON,
MILBANK, TWEED, HOPE & HADLEY,
15 Broad Street,
New York 5, New York

FORBES D. SHAW,
WHITMAN, RANSOM, COULSON & GOETZ,
40 Wall Street,
New York 5, New York
Attorneys for Western Realty Company, Appellee.

Dated: November 15, 1950

PARKER PRINTING COMPANY, 180 FIRST STREET, SAN FRANCISCO

SUBJECT INDEX

APPENDICES:

TABLE OF AUTHORITIES CITED

Cases

STATUTES AND REGULATIONS

No. 12,506

IN THE

United States Court of Appeals

For the Ninth Circuit

THE WESTERN PACIFIC RAILROAD CORPORATION and ALEXIS I. DUP. BAYARD, Receiver,
Plaintiffs and Appellants,
and

MEREDITH H. METZGER, HENRY OFFERMAN and J. S. FARLEE & CO., INC., a corporation,
Interveners and Appellants,
vs.

THE WESTERN PACIFIC RAILROAD COMPANY, et al.,
Defendants and Appellees.

Brief for Appellees

STATEMENT OF THE CASE

These are appeals from a judgment which denied all relief to ıppellants. Appellant, The Western Pacific Railroad Corpora-ion, a holding corporation which formerly owned all of the apital stock of the pre-reorganization The Western Pacific Rail-oad Company, brought suit against the reorganized The Western 'acific Railroad Company for $17,201,739.00 on account of "tax avings" of court trustees who operated the railroad properties uring the reorganization period. These "tax savings" were real-zed by the reorganization trustees primarily by reason of the entry

of the holding corporation's losses as deductions from income in consolidated tax returns. The contention is that the holding corporation, as parent of the group and as the "loss" member, is entitled to collect from the other group members the amounts thus "saved" by them in taxes. The claim is directed to the income of the reorganization trustees and the holding corporation seeks to assert that claim against the reorganized railroad company. The court below held that appellants have no cause of action and that approval of the claim would be in derogation of the reorganization plan and the purpose of Section 77 of the Bankruptcy Act.

The Facts.

1. THE PARTIES AND THEIR HISTORY.

Appellants are The Western Pacific Railroad Corporation, a Delaware holding corporation (Ex. P. 16), three of its preferred stockholders who have intervened to assert the Corporation's claims (R. 1650-52) and the receiver of the Corporation, which now has no assets and does no business. Appellees are The Western Pacific Railroad Company, a reorganized California railroad corporation, and its subsidiaries and a former affiliate. Appellants confuse three distinct entities by referring to all of them as "the company" or "defendant." These entities are

The pre-reorganization The Western Pacific Railroad Company, the stock of which was wholly owned by the Corporation;

The reorganization trustees, Messrs. Schumacher and Ehrman, who had title to and possession of the railroad properties from November, 1935, until December, 1944; and

The reorganized The Western Pacific Railroad Company in which the Corporation has no interest whatever.

It is against the latter, the reorganized company, that appellants seek judgment.

The Western Pacific Railroad Company was reorganized for the first time in 1916. The Corporation, a holding company, then acquired all the stock of the operating company (R. 493) and took charge of its affairs. In 1926 Thomas M. Schumacher became president of the Corporation and chief executive of the operating company (Ex. P. 34 B, R. 531, Ex. P. 21, R. 1719, Ex. P. 25, R. 1724); Michael J. Curry then became a vice president of the Corporation and a vice president of the operating company (Ex. P. 21, R. 1719, Ex. P. 25, R. 1724, R. 640); and in 1934 Pierce & Greer, counsel for the Corporation in this case, became, on Mr. Schumacher's recommendation (R. 793), general counsel for the Corporation and counsel for the operating company (R. 793, 1031). The Corporation's New York office was the head office of the group (R. 737) where policy was established and all significant decisions made (R. 740-42). The New York office was also made the fiscal office of the operating company (R. 740) and the office expense was divided between the Corporation and the company (R. 643-44). The Corporation in conventional fashion and for its own purposes created and maintained over the years the duality on which it now lays emphasis.

In 1925 Arthur Curtiss James acquired directly or through his companies approximately 61 per cent of the common and 8.8 per cent of the preferred stock of the Corporation (R. 501). From then and until February 1942 the James interests were represented on the Board of Directors of the Corporation (R. 1480, Ex. P. 22, R. 1720). Since that date no one of the Corporation's directors has been identified with any particular interest. During the years important here the Corporation's directors were Thomas M. Schumacher, a seasoned railroad executive (R. 993, 1231), past president of the Corporation and for many years chief executive of the Western Pacific system (R. 1719, 1724); M. J. Curry, for many years Mr. Schumacher's principal assistant (R. 736, 1135) described by the trial court as "a perfectly competent man,

intelligent, and probably a pretty good railroad man" (R. 785); A. Perry Osborn, an experienced New York lawyer who is of counsel for appellants in this action and who came to the Board at the suggestion of the Chase National Bank (R. 990); Willis D. Wood, a broker (R. 1121), past governor of the New York Stock Exchange (R. 1122) and director of many well-known companies (R. 1122-23); and H. Brua Campbell, a member of the firm of Pierce & Greer. The other four directors were office employees of the New York office appointed to fill vacancies occurring during the reorganization years (R. 1138-39). The officers of the Corporation were M. J. Curry and two office employees, Mary C. Valouch and J. F. Wienken (Ex. P. 21, R. 1719).[1]

2. THE REORGANIZATION.[2]

Between 1916 and 1935 the Corporation caused its subsidiary, the operating company, to sell securities in large amounts to the public. The Corporation was unsuccessful in its management of the company and by 1935 the company was unable to pay interest on its outstanding indebtedness of approximately $70,000,000 (230 I.C.C. 64). The Corporation directed it to file a petition for reorganization.

The railroad properties were transferred by the bankruptcy court to its reorganization trustees, Thomas M. Schumacher, president of the Corporation, who became a trustee upon its recommendation (R. 1627), and Sidney M. Ehrman, a San Francisco lawyer (R. 1223-24). Charles Elsey, president of the debtor and later to become president of the reorganized company, was managing agent for the trustees (R. 1224, 1251).

---

[1]For a tabulation of the officers and directors of the Corporation and their terms of service see Appendix A, p. 1.

[2]For the convenience of the Court a "Chronology of Reorganization Proceedings" and, in parallel therewith, a "Chronology of Tax Returns and Related Occurrences," have been prepared and have been placed in a pocket on the inside of the back cover to this brief. These chronologies will aid the Court in reviewing the sequence and relation of events.

The plan of reorganization formulated by the Interstate Commerce Commission (230 I.C.C. 61, 233 I.C.C. 409) limited the first mortgage bonds of the reorganized company to $10,000,000 to be exchanged for trustee's certificates (Par. O, 233 I.C.C. 451); it required the old first mortgage bondholders to exchange their securities for income bonds, preferred and common stock; and it declared that the stock interest in and unsecured claims against the old company were totally valueless (Par. P(5), 233 I.C.C. 452). Junior secured interests were not paid in full by at least $3,495,900, plus interest (Ex. D. 33, R. 2021). The Commission plan was approved by the Supreme Court (*Ecker v. Western Pacific R. Corp.,* 318 U.S. 448, 63 S.Ct. 692 (1943)) after review by this Court (*In re Western Pacific R. Co.,* 124 F.2d 136 (C.C.A. 9, 1941)) and the court below (*In re Western Pacific R. Co.,* 34 F. Supp. 493 (N.D. Cal. 1940)). In October 1943, after submission to and approval by the participating creditors, the plan was confirmed by the District Court (Ex. P. 10, R. 1674). A reorganization committee consisting of Frederick H. Ecker, representing institutional bondholders, Frank C. Wright, representing the Reconstruction Finance Corporation, and Robert E. Coulson, representing Railroad Credit Corporation and the A. C. James Company, was appointed (Ex. P. 10, R. 1674); the securities of the old company were surrendered with the approval of the reorganization court (Ex. P. 13, R. 1706) to the reorganization committee (Ex. P. 11, R. 1679) and later cancelled; new securities were issued; and on December 31, 1944, the railroad properties were turned over to the reorganized company, the appellee here (Ex. P. 14, R. 1711, R. 36-108). With the approval of the reorganization court (Ex. P. 13, R. 1706) and under authority of the reorganization plan (Par. R, 233 I.C.C. 453), the corporate charter of the old company was retained for the reorganized concern (Ex. P. 13, R. 1706). The reorganization proceeding was closed by a final order dated March 28, 1946 (Ex. D. 32, R. 2013).

The Corporation intervened in the reorganization on December 11, 1939 (Ex. D. 29, R. 1994) and thereafter remained a party to the proceeding, represented by Judge Marcus C. Sloss of San Francisco (R. 1600-03).

This litigation is a dispute about taxes[3] and "tax savings" for the years 1942, 1943 and the first four months of 1944, a period during which the railroad properties were owned, controlled and operated by the trustees of the bankruptcy court. It is a dispute about "tax savings" of those trustees.

The Corporation depended for its income on interest and dividends from securities of The Western Pacific Railroad Company and the Denver & Rio Grande Western Railroad Company (R. 748). With both the Western Pacific and Denver & Rio Grande properties in reorganization, the Corporation had no substantial income (R. 575) and its financial situation grew critical. For a time it succeeded in borrowing from its secured creditors to pay its office expenses (R. 771-72, 789, Ex. D. 4 C id., R. 1859). When these advances stopped, the Corporation renewed its earlier suggestion (Ex. D. 3, R. 1839, 1845, 1852-53) that the reorganization trustees assume a larger share of the New York office expense. The trustees, after consultation with the reorganization court (R. 1230-31) and to the knowledge of the Corporation's directors (R. 1002-3), agreed to assume and did assume all expense of the joint New York office (Ex. P. 30, R. 1738). The arrangement had no relation to income tax problems of the trustees (R. 1245, 1257). As an economy measure, Mr. Schumacher in 1942 resigned as president of the Corporation (R. 743) and Mr. Curry was elected by the Board as his successor (R. 644, 1016).

---

[3]On income earned by the railroad properties during the reorganization the trustees were the taxpayers. I.R.C. Sec. 52; *Reinecke v. Gardner,* 277 U.S. 239, 241, 48 S.Ct. 472, 473 (1928); *415 South Taylor Building Corp.,* 2 T.C. 184, 192 (1943). The trustees were entitled to join in the consolidated returns. I.R.C. Section 52, Treas. Regs. 104, Sec. 23.15(b).

3. TAXES PRIOR TO 1942.

In each year beginning with 1918 the Corporation prepared, signed and filed in New York consolidated tax returns for itself and all group members (R. 1258-59, 843-44, Ex. D. 40). Beginning in 1927 Mr. Curry, first as treasurer (R. 846) and after February 1, 1942, as president of the Corporation (Ex. P. 21, R. 1719) supervised preparation of the returns (R. 844-45) and signed and filed them (R. 846, 831, 664, 666). In each year the tax owing under those returns was allocated among the group members according to the formula universally accepted, that is: the consolidated return tax was distributed pro rata to those members of the group who had taxable incomes without allocating any tax to a "loss company" or paying that company for the tax "saved" by the use of the loss in the returns (R. 1262, Ex. D. 40). This approved practice was followed during the years here in question (Ex. D. 40).

4. TAXES FOR 1942.

During that part of the reorganization period prior to 1941, income was low and losses were large. No tax was reported owing in the consolidated returns and none was paid.[4] In 1942 it became apparent that the reorganization trustees, with substantial war income, might become liable for a large tax payment. Mr. Curry, who knew of the large earnings of the trustees and that the Corporation with no earnings would pay no tax (R. 836), supervised preparation of tentative consolidated returns for 1942, and signed and filed them on March 15, 1943 (R. 821) and arranged for an extension of time until May 15, 1943,

[4]In each of the years 1935 to 1941, inclusive, taxes were "saved" for one or more group members through the use of group losses in consolidated returns. No "tax savings" payments were made or demanded. See Ex. D. 40. (In this brief, exhibit references unaccompanied by record citations refer to exhibits which with leave of Court have not been printed.)

to file the final returns (R. 1881-82). Shortly thereafter F. C. Nicodemus, Jr., counsel for the Corporation, who had discussed the 1942 returns with Mr. Curry (R. 697-698), noting "the very critical question" as to whether the final returns should be consolidated or separate returns (Ex. P. 39-B, R. 544), suggested to Mr. Schumacher that the trustees obtain expert tax advice from the New York law firm of Whitman, Ransom, Coulson & Goetz (Ex. P. 39-B, R. 544, 1079). James K. Polk, a member of that firm, had worked with consolidated returns for many years both in and out of the Bureau of Internal Revenue (R. 1396-98). Mr. Schumacher consulted with Mr. Ehrman and they decided to employ the Whitman firm (Ex. P. 39-E, R. 1746, 1233).

Mr. Polk reviewed the tax history of the group (R. 1400), arranged for an independent tax accountant to assist the New York office employees in the preparation of the returns (R. 1402), considered various alternatives (R. 1404, 1444-45) and recommended that final consolidated returns be filed for 1942. The final returns, prepared in the New York office (R. 830), were signed and filed by Mr. Curry, president of the Corporation, on May 15, 1943 (R. 831, 837). They reported a consolidated tax of $4,201,821.54 (Ex. P. 3 A/B). With insignificant exceptions this tax resulted from the earnings of the reorganization trustees (Ex. D. 40) and the trustees provided from the bankruptcy estate the funds from which the tax was paid (R. 824, 826, 1306-07), allocating to the subsidiaries of the operating company in accordance with the traditional formula the small amounts of tax owing from them (Ex. D. 40).

5. TAXES FOR 1943.

Shortly after the 1942 returns were filed Mr. Polk reviewed the tax situation with Mr. Curry and Mr. Nicodemus, pointing out the advantages of consolidated returns (R. 839, 1079-1080),

and prepared a detailed written report dated May 20, 1943, which was addressed to Mr. Curry (Ex. P. 50, R. 1757) and circulated to Mr. Schumacher (R. 862) and Mr. Nicodemus (Ex. D. 9, R. 1884), who reviewed it together (R. 864). A copy of the report was provided to Mr. Elsey (R. 1266). The report reviewed the tax advantages of consolidated returns and suggested the possibility that under the recently enacted amendment to Section 23(g) of the Internal Revenue Code the loss of the Corporation, upon a determination that its stock in the old company was worthless, might constitute under consolidated returns an offset to income of other group members (Ex. P. 50, R. 1757).

During the fall of 1943 the courts finally determined that the Corporation's interest in the old company was worthless. The loss of the Corporation, calculated for tax purposes at $73,478,-023.04, greatly exceeded group income for 1943 (Exs. P. 4A, 4B, Ex. D. 40). As an economic matter the Corporation's loss had accrued over the years as the financial condition of the old company became increasingly acute; as a tax matter it was realized, according to Mr. Polk's opinion, when the order confirming the plan of reorganization became final in November 1943 (Ex. P. 54, R. 606, 1409-10). It was therefore a 1943 loss.

Consolidated returns reporting the loss of the Corporation as an offset to group income were prepared in the joint New York office (R. 1414), signed by Mr. Curry (R. 664), and filed by him on July 15, 1944 (Exs. P. 4A, 4B). Mr. Curry had been consulted from time to time in connection with the preparation of the returns (R. 1415) and he knew that they reported the Corporation's loss as a deduction (R. 682, 702-4). The returns reported no tax owing (Exs. P. 4A, 4B). Some months earlier the reorganization trustees, recognizing the uncertainties in the 1943 tax situation, had asked the reorganization court for leave to establish a reserve for taxes (Ex. P. 58, R. 1772). A hearing was held (R. 1270-74); the tax situation was reviewed (Ex. D.

34, R. 2023, 1270-74); and an order entered approving a reserve for tax purposes of $7,100,000 (Ex. D. 12, R. 1895). Judge Sloss and Mr. Nicodemus, attorneys for the Corporation, received notice of the hearing and the action taken (R. 1991, 1217). Mr. Curry understood that Mr. Nicodemus knew that consolidated returns would be filed for 1943 (R. 889). Mr. Nicodemus received a copy of Mr. Polk's written report of May 20, 1943 (R. 1884), a copy of the annual report of the trustees for 1943 which discussed taxes (R. 1086) and of the December, 1943, form 174A statement reporting the reversal of tax accruals (R. 1083-4).

6. TAXES FOR 1944 AND THE 1942 REFUND CLAIM.

Under the carryback provisions of the Internal Revenue Code (I.R.C. Sec. 122(b)) the group was entitled to carry back the 1943 loss and claim a refund of the tax paid for 1942. A refund claim, prepared by Mr. Polk as a routine matter (R. 1450), was signed by Mr. Curry (R. 667) and filed in due course on March 9, 1945 (Ex. P. 6, R. 1654).

The Internal Revenue Code also provided (I.R.C. Sec. 122(b)) that the 1943 loss could be carried forward to apply to 1944 income. The 1944 returns, reporting no tax owing (Exs. P. 5A, 5B), were signed and filed by Mr. Curry (R. 666) on July 15, 1945 (Exs. P. 5A, 5B). In the meantime and on April 30, 1945, the New York office had been closed (R. 650 A, 891) and Mr. Curry, after some preliminary conversation on his behalf by Mr. Nicodemus and Mr. Osborn with Mr. Coulson (R. 1017, 1110), had taken up quarters in the suite of Whitman, Ransom, Coulson & Goetz under a retainer arrangement whereby his services were to be available in connection with tax matters (Ex. P. 33, R. 529). The Corporation directors were familiar with this arrangement (R. 899, 901-03, 1017) and Mr. Curry testified that during the period he had his office in the Whitman suite no attempt was

made to influence his activities as Corporation president and that he was entirely free to take any action he thought advisable with respect to the Corporation's affairs (R. 904).

The returns for 1944 related only to the first four months of the year. On May 1, 1944, with the approval of the reorganization court (Ex. D. 23, R. 1930) and the stockholders of the Corporation (Exs. D. 1, D. 2, R. 1830-31), the stock of the old company held by the Corporation was surrendered to the reorganization committee (R. 493) and later cancelled, thus terminating the group affiliation and the possibility of consolidated returns.

7. THE SETTLEMENT WITH UNITED STATES.

Mr. Polk, holding powers of attorney from all group members (Ex. P. 65, R. 1784, R. 1441), represented the group in connecion with the audit of the returns. He wrote a letter (Ex. P. 64, R. 1779) to and held conferences with Bureau of Internal Reveiue representatives in New York and Washington (R. 1418-20, 423-31) which culminated in a proposal that the United States ccept the returns for 1942, 1943 and the first four months of 944 as filed and deny the refund claim designed to recover the 4,201,821.54 paid as 1942 tax (Ex. In. 14, R. 2142). This neant that the tax liability for the entire period of two years nd four months would be discharged by the payment of $4,201,-21.54. The Bureau eventually accepted this proposal (Ex. P. 7, . 1664-65).

Mr. Polk, with the approval of the reorganized company (Ex. . 72, R. 1801), which was responsible for the taxes of the ustees (Ex. P. 15, R. 1711), submitted his settlement proposal the Bureau on February 11, 1947 (Ex. In. 14, R. 2142). On pril 2, 1947, he advised the Corporation in detail (Ex. P. 68, . 1788). The directors of the Corporation, following agreement pon a stipulation in this proceeding, concluded by formal action approve the settlement (R. 1103, R. 1644-45) which on August

13, 1947 was also accepted by the Bureau (Ex. P. 7, R. 1664). The stipulation (Ex. P. 7, R. 1658) recognizes that although the settlement was effected in form by a total rejection of the refund claim, the $4,201,821.54 payment for 1942 was intended to be a settlement payment not for 1942 alone but for the entire period of two years and four months.[5]

From first to last these tax transactions were handled in the ordinary course of business. The returns related to a period during which affiliation continued—indeed they were possible only because affiliation continued—and they were prepared, signed and filed and the allocation of intra-group liabilities was made in strict accordance with twenty years of prior practice. Appellants have in fact no complaint about the tax returns. They agree that the returns were properly prepared, properly signed and properly filed (In. Br. 62-63, Pl. Br. 78-79). They also agree that Mr. Polk, whose purpose, like that of other tax counsel, was to obtain a favorable tax result for the group, discharged that duty in a completely satisfactory fashion. (R. 1007, 1103)

8. THIS LITIGATION AND THE OPINION BELOW.

In June, 1946, the interveners, claiming to own 6.7% of the preferred stock of the Corporation,[6] began a stockholders' suit

---

[5]Any refund which the United States might have made pursuant to the refund claim would have belonged to the reorganization trustees who paid the tax. In receiving the refund the Corporation would be acting as the agent for the actual taxpayer, Treas. Reg. 104, Sec. 23.16, and compelled to surrender the proceeds. *Bankers Trust Company v. Florida East Coast Car Ferry Company*, 92 F.2d 450, 452 (C.C.A. 5, 1937). Cf. *Hart Glass Mfg. Co. v. United States*, 48 F.2d 435 (Ct. Cl. 1931) cert. den. 286 U.S. 556; *Dorrance v. Phillips*, 85 F.2d 660, 662 (C.C.A. 3, 1936); *West Virginia Rail Co. v. Jewett Bigelow & Brooks Coal Co.*, 26 F.2d 503, 504 (E.D. Ky. 1928).

[6]Appellees offered to prove that the interveners bought their $100 par value preferred stock in the Corporation in 1942 and thereafter at a total cost of $37,007.39 or an average of $1.00 per share (Exs. D 18 id., 19 id., 59 id., R. 1905-07, 2102). The evidence was excluded as irrelevant (R. 1175, 1643).

in New York charging mismanagement of the Corporation by its officers and directors in many particulars, including failure to assert a "tax saving" claim. Thereafter and on October 10, 1946, the Corporation filed this action (R. 5).

The District Court concluded that there was no equity in appellants' claim and ordered judgment for appellees. The court, believing that there had been an erroneous and unjust "escape" from taxes which should have been paid to the United States, but "compelled to rest decision upon the fundamental issue of the justice and equity of plaintiff's right, if any, to be paid for that which was escaped" (R. 272), concluded that the injustice could not be cured by "distributing the gain thus made to others" (R. 271) and held that appellants had no claim.

The District Court recognized the true nature of appellants' claim:

> "A 'saving' in taxes is a negative concept. It is a benefit to one obligated to pay money, resulting from not having to pay. No benefit could inure from participating in non-payment of an obligation, unless there rested upon the participant an obligation to pay. Absent such obligation, any sharing of that which is not paid out, would be gratuitous." (R. 272-73)
>
> *   *   *   *   *   *   *
>
> "What plaintiff really seeks is not all or a share of the so-called tax saving. Rather it is a circuitous way of obtaining something in the nature of equity or value for its ownership, rejected in the reorganization plan. Or put differently, it is an effort to share in the earnings of the debtor during the reorganization period." (R. 272)

The court concluded that any such distribution of earnings would be contrary to the reorganization plan:

> "In effect therefore, recognition of plaintiff's claim would be recognition of a right in plaintiff to share in debtor's earnings. As already stated, a demand substantially seeking

this end was heretofore asserted by way of opposition to the plan and rejected. Ecker v. Western Pac. Co., 318 U.S. 448." (R. 273)

And contrary to the philosophy and purpose of the reorganization proceeding itself:

"Not only that, but the philosophy underlying Section 77 of the Bankruptcy Act stands as a barrier against the equitable validity of plaintiff's claim in this cause."

*　　*　　*　　*　　*　　*　　*

"When it was finally determined, after running the full gamut of court and administrative procedure, in the reorganization of the Western Pacific Railroad Company, that the plaintiff's interest was worthless, nothing short of some extraordinary cause justifying reopening the reorganization proceeding could effect a change. To make any award in this cause, under the assumed authority of equity principles, would be in effect to modify the administrative and judicial judgments in the reorganization proceeding. Such a procedure would be an indirect nullification of the purpose of the reorganization statute, in the guise of an afterthought allegedly of equitable persuasion." (R. 273-74)

The District Court therefore held

(a) that there is no justice or equity in appellants' claim;

(b) that to recognize the claim would be to accord appellants a share in the earnings of the reorganization trustees during the reorganization period;

(c) that to recognize the claim would mean that the Corporation would receive value for its stock ownership, although that stock has been held to be without value;

(d) that the Bankruptcy Act is a barrier against the assertion of appellants' claim against the reorganized The Western Pacific Railroad Company.

The District Court did not reach and had no occasion to consider the affirmative defenses of laches, statute of limitations and estoppel urged by appellees. Nor did the Court have occasion to give attention to the settled business practice, the past practice of the Western Pacific group, or the precedents relating to the distribution of intra-group liabilities in connection with consolidated returns.

9. THE "FACT" STATEMENTS BY APPELLANTS.

By seizing upon accidents of phrasing, by partial quotations, by distorting a few details and ignoring the substance of what was done,[7] appellants seek to lead this Court to believe that the con-

---

[7]The briefs of appellants, particularly that of the interveners, are replete with erroneous and misleading statements. We shall exemplify briefly.

(a) It is said that "defendant was quite reluctant to disclose its use of plaintiffs' tax credit * * * , it simultaneously decided to create a tax reserve; but this reserve was to be hidden under the unrevealing designation 'Reserve for Road Improvements' " (In. Br. 33). The fact is that the use of the stock loss in the 1943 consolidated returns was plainly disclosed in the returns, prepared in the Corporation's office (R. 845-46, 1414), signed and filed by the Corporation's president (R. 664). It was fully presented in a formal hearing in the reorganization proceeding (R. 1270-74) and reported in the annual reports published by the trustees (Exs. P. 20 B, 20 C, R. 511-14). As the trial court said, "It was all done right out in the open" (R. 970). The reserve to which appellants refer was established by court order (Ex. D. 12, R. 1895) and entitled "Reserve Fund for Contingent Tax Liabilities" (Ex. D. 12, R. 1895). Appellants, for their description of the reserve, rely upon a mere draft which was never used, which they have misquoted and which was to be entitled "Reserve Fund for Contingent Tax Liability and for Post-War Modernization and Improvement" (Ex. In. 19, id., R. 2155-56).

(b) Appellants say that "Plaintiff's financial collapse * * * was the signal for its officers, directors and lawyers to desert the sinking ship and to climb on that of defendant" (In. Br. 11). The fact is that the officers, directors and lawyers of the Corporation all testified that they performed their duties to the best of their ability, for the best interest of the Corporation and were not dominated or controlled in their actions by anyone (R. 743-44, 1011-16, 1046, 1126, 1136, 1143). There is no contradictory testimony.

(c) Appellants characterize Mr. Curry, the Corporation's president, as a "chief clerk" or "office manager" (In. Br. 12). The trial court, who heard him testify, characterizes Mr. Curry as "a perfectly competent man, intelligent, and probably a pretty good railroad man" (R. 785).

(d) Appellants say "without so much as asking plaintiff, defendant

duct of the persons handling the tax transactions was unfair and biased if not worse. These same arguments, based upon these same scraps of material, were pressed below with even greater

---

made the decision that plaintiff was to file consolidated returns and make its tax credit available to defendant" (In. Br. 18-19). The fact is that the Corporation's president himself signed and filed the returns (R. 663, 664, 666, 831, 837), that consolidated returns were obviously advantageous and that if they had not been filed appellants would have no claim.

(e) Appellants say that Mr. Polk's letter of May 20, 1943 was "addressed to defendant" (In. Br. 19). It was in fact addressed to Mr. Curry (Ex. P. 50, R. 1757), who was at that time an officer of both the Corporation and the pre-reorganization The Western Pacific Railroad Company. Mr. Curry has at no time been an officer of *defendant,* viz., the reorganized The Western Pacific Railroad Company.

(f) Appellants say that the consolidated returns for 1943 "were prepared by Valouch (then a full time employee of defendant, but neither an officer or director of plaintiff), under the supervision of Polk" (In. Br. 20). The fact is that the returns were prepared by Miss Valouch and Mr. Reilly, an independent tax accountant, under the supervision of Mr. Curry (R. 829-30, 701-02, 845-46, 1259, 1414). Mr. Polk had no part in the preparation of the returns but acted as tax counsel, that is, by giving advice (R. 1403-04, 1414-15, 1417).

(g) Appellants say of Mr. Curry after he took up his office in the suite of Whitman, Ransom, Coulson & Goetz, "he, as plaintiff's president, was to perform such services as defendant would require to achieve and safeguard the tax savings for itself" (In. Br. 21). The fact is that the retainer for Mr. Curry was arranged after Mr. Schumacher and Mr. Osborn had suggested that something be done for him because of the inadequacy of his pension (R. 1017, 1495), that he was retained in connection with tax affairs because of his familiarity with the tax matters of the group and possibly to act as a witness in pending tax matters (R. 1496-97), that Curry informed the Corporation's directors of the retainer (R. 1016-17, 899-904) none of whom disapproved (R. 903, 1017) and that he was at all times entirely free to carry out his activities as president of the Corporation with no interference whatever (R. 904).

(h) Intervener appellants say that on August 13, 1947, the tax settlement with the United States "became an accomplished fact, without ever having received advance approval by plaintiff" (In. Br. 25). The fact is that prior to the receipt of information of the Government's action the directors of the Corporation had considered the matter at length and decided against withdrawal of the offer of settlement (R. 1644-5).

(i) Appellants say that not until shortly before this action was filed did either Mr. Osborn or Mr. Wood know "that the plaintiff's stock loss was being used in tax returns or that thereby defendant was saving taxes; neither knew or was advised of the legal or economic consequences of the filing of the returns involved in this case" (Corp. Br. 12). The fact is that Mr.

vigor. They failed to make any impression on the trial court. That court had before it as witnesses, on the call of appellees, the persons whom appellants by innuendo charge with conniving or incompetence: Curry (R. 636-910), Nicodemus (R. 1029-1121), Osborn (R. 988-1029), Polk (R. 1396-1477), Coulson (R. 1478-1501), Ehrman (R. 1222-49), and Elsey (R. 1249-1361). The depositions of Sheehan (R. 1138-43), Wood (R. 1121-34), Hatton (R. 1134-38), and Sloss (R. 1599-1614) were read in whole or in part. With the witnesses and the written record before him, the District Judge concluded that there was no reason to believe that the tax transactions were handled other than in an open, competent, candid and unbiased fashion and cut short the exposition of the details (R. 970, 977, 986) and intervener's argument concerning them. The court said:

> "The Court: Well, I can follow all that argument or I could if there were some concealment involved. But when everybody was, as they were in this case, acting completely in the open in the matter, nobody was concealing anything from anyone else, the element of fraud or deception, of the kind that you refer to, is absent.
>
> * * * * * * *
>
> "Everybody knew that consolidated returns were being filed. Everybody knew who the directors were. Everyone knew that these attorneys were being employed to file this consolidated return. It was all done right out in the open." (R. 970)

Osborn knew that consolidated returns were being filed (R. 1019) and that they conferred substantial benefits on the trustees (R. 1020-22). Mr. Wood had no doubt that consolidated returns would be filed (R. 1132-3).

(j) Appellants say that by reason of the stockholders' suit filed in June 1946 "plaintiff's board of directors first learned of the use of plaintiff's stock loss in consolidated returns to the advantage of the defendant Operating Company" (Corp. Br. 24). The fact is that Mr. Curry knew of the use of the Corporation's loss as a deduction at the time the 1943 returns were filed (R. 682, 702-4), that Mr. Schumacher was familiar with the tax transactions throughout (R. 876-77), that Mr. Osborn knew that consolidated returns conferring a benefit on the trustees were being filed (R. 1019-22), and that Mr. Wood had no doubt that consolidated returns would be filed (R. 1132-33).

SUMMARY OF THE ARGUMENT

Appellants claim for the Corporation, as former owner of the stock of the pre-reorganization The Western Pacific Railroad Company, the benefit of the "tax saving" realized by the reorganization trustees through the entry of the Corporation's loss as a deduction from income in the consolidated returns. That claim fails: first, because it is without merit; second, because it is presented against a party not liable, viz., the reorganized The Western Pacific Railroad Company; and, third, because it is presented too late and in the wrong forum.

The District Court believed that the use of the Corporation's loss as a deduction from income in the consolidated returns was not intended by the revenue laws. Appellants and appellees are agreed that the returns were proper under the tax laws and that the settlement of tax liability with the Government was also proper. In either view of the intent of the revenue laws, the Corporation's claim must fail. If it be assumed that the use of the Corporation's loss to offset taxable income resulted in an under-payment of taxes to the United States, no right would on that account vest in the Corporation. Alternatively, if the "tax saving" was intended by the revenue laws and the taxes due the United States were fully paid, the Corporation is merely attempting to assert, without justification, a claim to a portion of the income earned by and belonging to the reorganization trustees.

There is a well recognized and generally accepted formula for settling intra-group affairs in connection with consolidated returns. It calls for an apportionment of the consolidated tax in proportion to taxable incomes with no "tax saving" payment. The Securities and Exchange Commission has by rule established that formula for the utility industry. The Treasury Department has approved it. It is generally employed by the business community and it has been followed without deviation for twenty years by the Western Pacific group at the direction of the Corpo-

ration itself. Appellants are attacking a practice which has been followed without challenge since the income tax laws were first enacted. Their position has never been approved and it has been specifically condemned.

Appellants' case lacks the fundamentals of any legal action: proof of wrong and proof of damage. The entry of the loss of the Corporation as a deduction from income in the consolidated returns did not affect the Corporation nor damage it in any way. It paid no taxes under the consolidated returns. It would have paid none under separate returns.

Appellants have no unjust enrichment claim. In law the trustees were not "enriched" by retaining income they had earned in operating the railroad properties. Even if this were an enrichment, it was not unjust to appellants. The failure of appellants to show injustice *to them* is fatal to their claim. Moreover, under the circumstances of this case, any unjust enrichment recovery, even if a claim could be made out, would necessarily be nominal. Against a defendant whose conduct has not been tortious or wrongful (and certainly *these appellees* are guilty of no wrong) a judgment for unjust enrichment is limited to the gain to the defendant or the loss to the plaintiff, *whichever is the lesser*. In his case the plaintiff suffered no loss.

The dual employment of the personnel who handled the tax ransaction is of no significance. Duality in itself is not a wrong, or does it give rise to liability in the absence of wrong. Moreover, if, as appellants argue, they are entitled to "fairness" hey still have no claim. The best proof of "fairness" is the venty years of past practice of the Corporation itself, the settled ractice of the business community and the conclusion uniformly xpressed by all who have considered the problem of intra-group ractices in connection with consolidated returns—all of which e in strict accordance with what was done in this case and dictly opposed to what appellants seek to have done.

In this equity proceeding appellants are without equity. The present owners of the reorganized company are the secured creditors (and their successors in interest) of the old company. The claims of those creditors have never been paid in full. The stock and other securities which they received in the reorganization have never been equal in value to their claims against the old company. The Corporation, as parent company, owed fiduciary duties to these creditors of its subsidiary. It was obligated to protect their interest, either by joining in consolidated returns or otherwise. Certainly, as fiduciary, the Corporation cannot be allowed to reduce the assets of the reorganized company by $17,000,000 and thus further diminish the already inadequate recovery of the secured creditors of its subsidiary.

Appellants' claim, even if it had substance, cannot be asserted against appellees. The taxes which were "saved" were taxes of the reorganization trustees; a claim for the "saving" is a claim against those trustees. The trustees, however, are not parties to this action and the assumption agreement by which the reorganized company undertook to pay certain trustee obligations does not include this claim. Even if appellants had a claim against the reorganization trustees, they have none against appellees.

Appellants' claim is barred by the failure to present it during the reorganization proceeding. The "tax saving" claim, if paid, would have been an expense of administration of the reorganization proceeding. Such expenses have validity and can be paid only if they are approved and allowed by the reorganization court. This claim was neither presented to, approved by nor allowed by that court.

The principal purpose of the reorganization would be frustrated if appellants were allowed judgment for $17,000,000 against the reorganized company (an amount nearly twice the authorized first mortgage bond issue of the reorganized company) on the basis of a claim relating to the period of reorgan-

ization but which was neither advanced nor considered in that proceeding. Any such judgment would frustrate the purpose of the reorganization; it would repudiate the conclusion of the Supreme Court that appellants' interest in the Western Pacific group was valueless; and it would be in derogation of the provisions of the reorganization decrees barring all claims not specifically approved and allowed.

Argument

I. APPELLANTS HAVE NO CLAIM.

By this litigation appellants seek a retrospective examination of the proceedings taken in connection with the income and excess profits taxes of the reorganization trustees of The Western Pacific Railroad Company. The tax proceedings were carried on in a routine, open fashion according to procedures which had been followed for many years. The reorganization court, the trustees and all who participated in the tax proceedings understood that there was a possibility that the Government would not accept the returns as filed and, accordingly, a tax reserve was created. The possibility that the Corporation might assert a claim occurred only to the attorney for the Corporation, who consulted expert tax lawyers in that connection. They gave him no encouragement. Some years later, after the reorganization was completed and closed, certain stockholders of the Corporation brought a suit in which the claim made here was asserted for the first time. Shortly thereafter the Corporation filed this action. The District Court observed that the claim is novel and bizarre and that it is an afterthought pursued on account of the large amount involved. These facts are not recommendations for appellants' claim, but since it is earnestly pressed, this brief points out some of its defects.

The first question is: Does the fact that the entry of the Corporation's loss in the consolidated returns reduced the taxes of the reorganization trustees vest a money claim in the Corporation? If it does not, if the Corporation has been deprived of nothing to which it is entitled, arguments about fairness, duality and fiduciary obligations are all irrelevant.

Consolidated returns have been filed in great numbers since the early years of the income tax law. One consequence is that specific and dependable guides for the proper settlement of intra-group liabilities in connection with those returns are now available. They are

> The past practice of the parties and the general practice of the business community.
>
> The rulings of the Securities and Exchange Commission and the Treasury Department.
>
> The studies of affiliated groups by the Federal Trade Commission and the decisions of the Interstate Commerce Commission.

These, the relevant guides for decision, unlike appellants' arguments,[11] all relate precisely to the matter in hand. They demonstrate that the decision below is in accordance with all the precedents and settled practice. In attacking those precedents and that practice appellants fail to prove a cause of action.

A. Appellants Have No Claim Based on the Failure, if Any, to Pay Taxes Due the United States.

Appellants claim moneys which were earned by the reorganization trustees in the operation of the railroad properties. The

---

[11] Appellants cannot agree on what this Court should do or why it should do it. The Corporation wants judgment for $17,201,739.00; the interveners will be content with what "to this Court may appear fair in the circumstances of this case" (In. Br. p. 69). The Corporation stresses unjust enrichment; the interveners stress duality. The Corporation says little about a possible bargain with the trustees; the interveners place heavy emphasis on the bargain idea. Nothing which appellants say, however, furnishes any justification for overturning the settled practice of the parties.

court below concluded that those moneys belong either to appellees as railroad revenues or to the United States as taxes—and that in neither event do appellants have a claim. The court also thought that the tax result reached here was contrary to the intent of the revenue laws and that no "tax saving" should have occurred. The trustees paid no tax on large amounts of income as a result of a literal application of I. R. C. Sec. 23(g)(4) to the circumstances here presented. That section permits the loss to a taxpayer corporation when the stock of an affiliated corporation becomes worthless in its hands to be treated for tax purposes as an ordinary loss rather than a capital loss and hence available as an offset to ordinary income. Normally, however, the taxpayer's loss on the stock of an affiliate offsets income of the taxpayer or another affiliate. Here the loss offset for tax purposes the income of the properties of the very company whose stock was declared worthless. This result followed, however, from the express language of the statute. But because of the uncertainty as to the year of loss,[12] an uncertainty as apparent to the Bureau as to the taxpayer,[13] a settlement was made whereby the United States accepted $4,201,821.54 in full discharge of the group tax liability for the period in question.

The court below believed that the Bureau exercised poor judgment in accepting this compromise. Appellees disagree. If, however, this Court should share the view of the District Court on this aspect of the case, it must inevitably reach the same conclusion: that appellants have no claim on tax moneys. Appellants are not tax collectors. To prevail they must establish their own rights. They cannot rely on the rights of the United States. "Re-

[12]The Bureau argued initially that the loss related back to the initial approval of the reorganization plan in August 1940 and that it was therefore a 1940 loss and not available to offset 1943 income (R. 1423-26).

[13]The record demonstrates that the Bureau representatives had complete and detailed information on all aspects of the tax transaction. See R. 1418-20, 1423-30, Ex. P. 64, R. 1779.

spondents, to have standing in court, must show an injury or threat to a particular right of their own, as distinguished from the public's interest in the administration of the law." *Perkins v. Lukens Steel Co.*, 310 U.S. 113, 125, 60 S.Ct. 869, 876 (1940); *Stark v. Wickard,* 321 U.S. 288, 304, 64 S.Ct. 559, 568 (1944).

B. Appellants Have No Claim Based on Unjust Enrichment, Fiduciary Obligations or Duality.

The briefs of appellants discuss doctrines of unjust enrichment, fiduciary obligation and duality. Those doctrines provide, however, no support for appellants' claim.

1. APPELLANTS HAVE SUFFERED NO WRONG AND PROVED NO DAMAGE.

Appellants do not prove a cause of action. They have no title claim. The funds they seek came from shippers in exchange for transportation service. They have never belonged to appellants. With no title to assert appellants, as other litigants, must prove that they have been wronged and damaged. They prove neither. In 1943 the courts gave formal recognition to the financial truth that over the years the interest of the Corporation in the old company had become worthless. Congress authorized a tax calculation whereby an entry was made in consolidated returns deducting the amount of the Corporation's loss from the income figures appearing in the returns. Returns thus prepared were filed and audited and the group liability was compromised and satisfied. Nothing in this process constituted a wrong to appellants. They suffered no tort; no contract was breached; no statutory right was infringed. Appellants have, therefore, no standing in court. "The only injury of which plaintiffs may complain in a judicial tribunal is the invasion of some legal or equitable right." *Tilney v. City of Chicago,* 134 F.2d 682, 683 (C.C.A. 7, 1943) cert. den, 320 U.S. 759.

Nor have appellants been damaged. The Corporation paid no tax under the consolidated returns (Ex P. 3A/B, 4A/B, 5A/B)

just as it would have paid no tax under separate returns. (Ex. D. 46, R. 2040) The reference in the returns to the fact of its loss cost the Corporation nothing. The Corporation had no income (Exs. D. 40, D. 46, R. 2040). It could not have used the loss itself[14] and it could not have sold it.[15] The Corporation has thus proved no damage and without proof of damage no litigant can recover. "The damages recovered by an injured party have always been limited to his 'actual damages'." *Connecticut Ry. Co. v. Palmer,* 305 U.S. 493, 504, 59 S.Ct. 316, 323 (1939). "Wrong without damage or damage without wrong does not constitute a cause of private action * * *." *Clark Oil Co. v. Phillips Petroleum Co.,* 148 F.2d 580, 582 (C.C.A. 8, 1945), cert. den, 326 U.S. 734.

2. APPELLANTS HAVE NO UNJUST ENRICHMENT CLAIM.

Nothing in the law of unjust enrichment suggests that appellants have a claim. The failure of the reorganization trustees to pay additional taxes was not, in contemplation of law, an enrichment. Even if it were, the enrichment was not unjust to appellants and without proof of injustice *to them* appellants cannot recover. Finally, where, as here, the defendant is not a wrongdoer unjust enrichment recovery can never exceed the actual loss to the plaintiff—in this case, nothing.

(i) Appellees Were Not "Enriched."

If separate returns had been filed for the years in question, or

[14]The consolidated returns and the refund claim applied only a portion of the stock loss against income of the reorganization trustees. From the balance of the loss amounting to more than $42,000,000 (Ex. D. 40, D. 52A) appellants have not been able to derive any gain whatever—proof positive that no damage has been suffered.

[15]In *J. D. and A. B. Spreckels Co. v. Commissioner,* 41 B.T.A. 370 (1940), the taxpayer had acquired the stock of a subsidiary in order to take advantage of a tax loss which the subsidiary was about to realize. The loss was taken and the taxpayer sought to claim the loss as a deduction in a consolidated return. It was held that since the acquisition of the stock had no business purpose the loss could not be allowed.

if there had been no reference in the consolidated returns to the Corporation's loss, the trustees would have paid additional taxes. The difference would not have been $17,201,739.00 as appellants suggest and the District Court assumed, but some substantially smaller figure, the exact amount of which is highly uncertain.[16] But whatever the proper calculation, a "saving" of taxes is not an "enrichment." Congress expects that the deductions provided for by the Revenue Acts will be taken. "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." *Gregory v. Helvering,* 293 U.S. 465, 469, 55 S.Ct. 266, 267 (1935).[17]

---

[16]Since there is no such thing as a "normal" tax (see footnote 23 in Part VI of Securities and Exchange Commission Release No. 53, Accounting Series, November 16, 1945), the computation of any so-called "tax saving" requires a comparison between the tax actually paid and a hypothetical tax which might have been paid. A calculation of the amount of the alleged "tax saving" here involved requires such a comparison between the actual tax and a hypothetical tax which the reorganization trustees would have paid if the Corporation's stock loss had not been available as a deduction. The computation and amount of the hypothetical tax were debated at length at the trial, both orally and upon brief. Tax experts were called as witnesses by both sides (R. 911-955; 1501-1576; and 1583-1585), and they disagreed by several millions of dollars as to the proper computation. In fact, the appellants' own expert presented three alternative and widely varying computations (Ex. P. 80, R. 1825-1829). Among the questions to be decided in determining the hypothetical tax are the following: (a) Should the hypothetical tax be computed on consolidated or separate returns? (b) How should the loss carry-overs and unused excess profits credits of the reorganization trustees be treated? (c) Should intercompany interest accruals and other intercompany transactions be considered? (d) What effect should be given to the accelerated amortization deductions, the freight refunds and the government's pending freight reparation claims? (e) Should alternative tax saving methods be taken into account? (f) Should effect be given to the partial worthlessness of the large debt owed to the reorganization trustees by Sacramento Northern Railway? Each of these is a difficult and complex problem which must be solved before the amount of the hypothetical tax can be properly computed. The trial court concluded, however, that the appellants were not entitled to any part of the tax saving and consequently the court had no occasion to determine its amount or to consider or decide any of the problems involved.

[17]For a criticism by the Securities and Exchange Commission of the entire concept of a "tax saving" see Appendix B, p. 7.

(ii) Assuming An Enrichment, It Was Not Unjust to Appellants.

Even assuming that a lawful calculation of taxes could be called an "enrichment," and assuming, further, that the benefit to the trustees was brought about by the Corporation, appellants still have no claim. "The mere fact that a person benefits another is not of itself sufficient to require the other to make restitution therefor." (*Restatement of Restitution,* Sec. 1, p. 13.) "But, in order to establish unjust enrichment it is not enough merely to show one's retention of the benefit. The retention must also be unjust." *Bailis v. R.F.C.,* 128 F.2d 857, 859 (C.C.A. 3, 1942). The instances in which a plaintiff has conferred a benefit on a defendant and failed to obtain judgment are legion.[18] To succeed, a plaintiff must prove injustice to him. The doctrine is a doctrine of restitution. The plaintiff must show that something was taken from him and that there is some recognized basis—fraud, mistake, duress, undue influence, illegality—for revoking the transfer.

One consequence is that in every windfall situation, such as ap-

---

[18]The cases include (a) cases where, as in this case, there has been a long course of dealing without payment, see *Country Club District Service Co. v. Edina,* 8 N.W.2d 321 (Minn. 1943), *Wright v. Sheldon,* 53 Atl. 59 (R.I. 1902); (b) cases where, as in this case, there has been a mutual exchange of benefit, see *Potter v. Carpenter,* 76 N.Y. 157 (1879), *Allen v. Bryson,* 25 N.W. 820 (Iowa 1885), *Gross v. Cadwell,* 30 Pac. 1052 (Wash. 1892); (c) cases where, as in this case, the enrichment of defendant cost plaintiff nothing, see *Boston v. District of Columbia,* 19 Ct. Cl. 31 (1883), *Erickson v. Hochbrune,* 91 Pac. 485 (Wash. 1907); and (d) cases in which services were performed or a benefit transferred under circumstances in which the defendant did not expect to pay even though the plaintiff expected to receive compensation, see *Concord Coal Co. v. Ferrin,* 51 Atl. 283 (N.H. 1901), *Peters v. Adams,* 190 N.Y.S. 220 (Cty. Ct. 1920), aff'd 188 N.Y.S. 945 (App. Div. 1921), *Dusenka v. Dusenka,* 21 N.W.2d 528 (Minn. 1946).

If the claim in this case is in reality a claim for service by the Corporation in assisting the trustees in protecting the railroad properties against demands for taxes, no compensation may be required of appellees for the reason, among others, that in view of the past practice, in which no payment was made for the use of losses, the trustees could not have expected to make any such payment.

pellants claim this to be, the defendant prevails. In *Straube v. Bowling Green Gas Co.,* 227 S.W.2d 666 (Mo. 1950), plaintiffs paid for gas at rates based upon charges made to the gas company by its suppliers. During litigation over the validity of an order reducing the rates of the supplier the difference between the new and the old rates was impounded and later paid to the gas company. Plaintiffs' unjust enrichment argument failed. "Since the facts alleged show no 'unjust privation' of appellants and no legal or equitable rights in appellants as to either fund, there could be no 'unjust enrichment' of respondent at the expense and loss of appellants." (227 S.W.2d 671). In *Houck v. Hubbard Milling Co.,* 167 N.W. 1038 (Minn. 1918), the defendant received refunds resulting from revision of freight rates. Plaintiff, who had made sales to defendant on the assumption the existing rates were to apply, attempted to claim the refunds. "The refunds amount to a find for the defendant. * * * No legal equity puts a right of recovery in the plaintiff." (167 N.W. 1039.) In *Consolidated Cut Stone Co. v. Seidenbach,* 114 P.2d 480 (Okla. 1941), subcontractors gave the owner certain credits on account of defaults of the general contractor. A surety later compensated the owner for the same defaults. The subcontractors, arguing unjust enrichment, attempted without success to obtain judgment in the amount of the credits. "Unless these appellants had rights existing prior to or at the time payment was made * * * which were violated or altered by the payment, the mere fact of excess payment can give them no right." (114 P.2d 484.) In *Greek Catholic Congregation of Borough of Olyphant v. Plummer, et al.,* 32 A.2d 299 (Pa. 1943), plaintiffs failed to recover from defendant royalties which defendants had received on coal which belonged to plaintiffs. "In every case of 'unjust enrichment' the courts have been able to point out some wrong done by the party enriched. By 'wrong' is meant, of course, the violation of another's legal right." (32 A.2d 300.) In *Russo v. Hosmer, Inc.* 44 N.E.2d

641 (Mass. 1942), Hosmer was paid by Massachusetts for work he had illegally contracted to Russo who sought relief in quantum meruit. Russo's claim was denied. "He [Russo] was not damaged nor affected by the failure to observe the provisions in Hosmer's contract with the Commonwealth governing the subletting of the work." (44 N.E.2d 644) In *Vanderbilt University v. Williams,* 280 S.W. 689 (Tenn. 1926) defendant received rent for land over which he and plaintiff had identical easements which entitled neither to rent payments. Plaintiff's claim for half of the rent was denied: "Equity may not be invoked to supply a remedy until a right, legal or equitable, exists." (280 S.W. 692.)

Thus the cases make it clear that a windfall to appellees vests no claim in appellants unless appellants can demonstrate injustice to them by an invasion of rights which the law recognizes. The rights of appellants have not been invaded. They cannot recover.

(iii) Appellants' Unjust Enrichment Recovery Could Not in Any Event Exceed the Actual Loss to Them.

The law of unjust enrichment recognizes three situations: (a) that in which the defendant is free from fault; (b) that in which the conduct of defendant is tortious; and (c) that in which the defendant is a conscious wrongdoer. If the defendant is free from fault, the judgment, assuming a case is made out, is limited to the loss to the plaintiff or the benefit to defendant, *whichever is lower.* "If the [defendant] was no more at fault than the claimant, he is not required to pay for losses in excess of benefits received by him and *he is permitted to retain gains which result from his dealing with the property." (Restatement of Restitution,* p. 596 and see the illustrations, pp. 356 and 618.)

The cases agree. A surety, for example, who pays an obligation of his principal at a cost to the surety less than the obligation discharged can recover only his outlay. If, for instance, he

pays the principal's debt in depreciated currency, he recovers only the cost of the currency to him.[19]

If, therefore, appellants' case rests upon unjust enrichment, appellants can at most demand no more than a nominal judgment. Plainly there was nothing wrongful in the handling of the tax transaction. The Internal Revenue Code provides for consolidated returns; the stock loss deduction is within the plain language of Section 23(g)(4); liabilities within the group were determined in accordance with the formula universally recommended and which the parties had followed for twenty years. Taxpayers who follow twenty years of past practice and the unanimous precedents are not conscious wrongdoers or tort feasors. Unjust enrichment recovery could not, therefore, exceed in any event the gain to appellees or the loss to appellants, *whichever is lower.* Appellants suffered no loss; they can have no judgment.

3. APPELLANTS HAVE NO CLAIM ARISING FROM FIDUCIARY OBLIGATIONS.

Appellants attempt to support their position by contending that fiduciary obligations were operating in favor of the Corporation in connection with the tax transactions. The argument is unsound. In those transactions the Corporation was itself charged with fiduciary duties and its position was in no respect that of a cestui que trust.

(i) The Corporation Was Charged with Fiduciary Obligations.

The taxes under discussion are taxes for a period in the trusteeship prior to May 1, 1944, a period when the Corporation was

---

19See, for example, *Bonney v. Seely,* 2 Wend. 481 (N.Y. 1829): "If the plaintiff had paid the defendants' debt by paying half the amount, can he recover the whole from the defendants? I think not. He is entitled to recover the amount paid, not the amount extinguished by that payment." See also *Kendrick v. Forney,* 22 Gratt. 748 (Va. 1872); *Butler v. Butler's Administrator,* 8 W. Va. 674 (1873); *Succession of Dinkgrave,* 31 La. Ann. 703 (1879); *Hall v. Creswell,* 12 Gill & Johnson 26 (Md. 1841).

the sole stockholder of the old company. As parent, the Corporation had fiduciary responsibilities to its subsidiary and particularly to the subsidiary's creditors, the present stockholders of appellees. "A holding company * * * has fiduciary duties to security holders of its system which will be strictly enforced." *Consolidated Rock Products Co. v. DuBois,* 312 U.S. 510, 522, 61 S.Ct. 675, 683 (1941). "* * * Inland, by reason of its entire ownership and control of Michigan, occupied a fiduciary position requiring scrupulous observance of its obligations to safeguard and preserve the interest of Inland bonds, and owed to its bondholders, a duty not to impair the value of the Michigan stock." *In re Commonwealth Light & Power Co.,* 141 F.2d 734, 736 (C.C.A. 7, 1944). See, also, *Comstock v. Group of Institutional Investors,* 335 U.S. 211, 68 S.Ct. 1454 (1948). The fact that the returns were physically filed after the Corporation surrendered its stock does not affect the Corporation's obligations. The returns related to the period of affiliation and the obligations of the parties with respect to them were therefore the obligations of the affiliation period. The obligations of a fiduciary upon termination of the relationship continue unimpaired with respect to all past transactions and the incidents of winding up. The rule applies to all fiduciary relationships: partnerships, agencies, trusts and corporate affairs.[20] The Corporation had, therefore,

[20] *To Partnerships:* "On dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed." Uniform Partnership Act, 7 U.L.A. Sec. 30; Cal. Corp. Code Sec. 15030.

To Agencies: "The duty of an attorney to be true to his client, or of an agent to be faithful to his principal, does not cease when the employment ends, and it cannot be renounced at will by the termination of the relation. It is as sacred and inviolable after as before the expiration of its term." *Trice v. Comstock,* 121 Fed. 620, 625 (C.C.A. 8, 1903).

To Trusts: "When the time for termination of the trust has arrived, the duties and powers of the trustee do not immediately cease, but until the trust is actually wound up, he has such duties and powers as are appropriate for the winding up of the trust." 3 *Scott on Trusts* (1939) Sec. 344.

To Corporations: "* * * by statute in most jurisdictions it is now provided that upon the dissolution of any corporation in any manner, or upon

fiduciary obligations with respect to the tax transactions which were entirely unaffected by the date the returns happened to be filed. Those fiduciary duties required that the Corporation cooperate in minimizing taxes for the benefit of the unpaid creditors of the old company, the present stockholders of appellees. As fiduciary, the Corporation was not entitled to prefer its own interest over the interest of those unpaid creditors by demanding a "tax saving" payment of $17,000,000.00 on account of an entry in the tax returns which cost the Corporation nothing. The fiduciary obligations which the law recognizes for the circumstances of this case do not support the claim of appellants; they support the judgment below.

(ii) The Position of the Corporation Was Not That of a Cestui Que Trust.

Appellants seek to reverse the fiduciary obligations imposed by law and place the Corporation in the position of a cestui que trust by an attack upon the Corporation personnel who handled the tax transactions. The fact is, however, that the officers and directors of the Corporation were both competent and informed. The directors included Mr. Schumacher, "a very experienced railroad man" (R. 1231) characterized by counsel for appellants as a man "of great ability and great honesty of character" (R. 993); Mr. Wood, a man thoroughly experienced in large financial affairs (R. 1122-23) and who had special experience in reorganization matters (R. 1123); two well qualified New York lawyers, Mr. Osborn and Mr. Campbell, each of whom are of counsel for the Corporation in this case; and Mr. Curry, president of the Corporation, described by the court below as "a perfectly competent man, intelligent, and probably a pretty good railroad man" (R. 785). As lawyers the Corporation had, for the reorganization proceeding, Judge Sloss of San Francisco, whose competence and integrity

---

the expiration of its period of corporate existence, the directors at the time of the dissolution shall be the trustees of the creditors and stockholders of the corporation * * *." 16 Fletcher, *Corporations* (Perm. Ed.) Sec. 8174.

are beyond question (R. 1600-03), and as general counsel, Pierce & Greer, counsel in this case, who for thirty years have represented large railroad organizations (R. 1030) who were actively prosecuting various claims on behalf of the Corporation during the period in question, including another suit against these appellees (R. 1048-52) and whose senior partner, Mr. Nicodemus, was sufficiently experienced in tax matters to be chairman in 1943 of a special tax committee organized by the railroads (R. 1034-35). As an unimpeachable source of information the Corporation had the fact that the tax returns were prepared in its office (R. 829-30, 844-46, 1258-59, 1414) as long as the office was open (R. 891, 1287) and signed and filed by its president (R. 663-66, 831, 837). The Corporation had, in addition, Mr. Polk's oral report on tax affairs to Mr. Curry and Mr. Nicodemus on May 18, 1943 (R. 839, 1079-80), Mr. Polk's letter of May 20, 1943 (Ex. P. 50, R. 1757) reviewing the tax situation, the annual reports of the trustees which discussed tax problems (Exs. 20-B, 20-C, R. 511-14, 1279) and the hearing held by the reorganization court reviewing the tax situation and establishing a tax reserve (R. 1991, 703, 1085).[21] Mr. Curry, Corporation president, who had handled tax matters for the Western Pacific group for many years (R. 841-45)

[21]The petition of the trustees for an order to establish a reserve fund of $7,100,000 for contingent tax liabilities was filed on February 21, 1944 (Ex. P. 58, R. 1772). Judge St. Sure, by an order dated February 21, 1944, set March 3, 1944, as the date for a hearing on the petition and specifically required the trustees to give notice to and send a copy of the petition and the order setting the date of the hearing to the Corporation (Ex. D. 28, R. 1991). On March 3, 1944, a hearing on the petition was held during which Mr. Elsey testified substantially as indicated by Ex. D. 34 (R. 2023): that under consolidated returns the plaintiff's loss would offset trustee income, but that until the returns were accepted by the Bureau of Internal Revenue there was a possibility of litigation resulting in a substantial tax liability, and thus that the trustees deemed it prudent to establish a reserve for contingent tax liability in the amount indicated (R. 1271-74). By its order of March 3, 1944, the bankruptcy court authorized the trustees to establish the fund (Ex. D. 12, R. 1895). In connection with 1944 taxes the reserve was later increased to a total of $10,100,000 (Exs. P. 20C, P. 20D, R. 515-16).

and who appreciated the difference between consolidated and separate returns (Ex. D. 56, R. 2087-90), thoroughly understood the tax situation and wrote to Mr. Nicodemus explaining it (Ex. In. 5, R. 2125); Mr. Schumacher was familiar with the tax transactions throughout (R. 876-77); Mr. Osborn, another director, knew that consolidated returns were being filed (R. 1019) and that they conferred substantial benefits on the trustees (R. 1020-22); Mr. Wood had no doubt that consolidated returns would be filed (R. 1132-3). The possibility of a "tax saving" claim for the Corporation occurred to Mr. Nicodemus, Corporation counsel, and he discussed it with three prominent tax lawyers, Thomas Tarleau, who had recently been legislative counsel for the Treasury (R. 1059), Leslie Rapp, formerly minority clerk of the House Ways and Means Committee (R. 1059-60) and Claude Dudley, who was associated with Mr. Nicodemus in his efforts to obtain favorable tax legislation from Congress (R. 1063). Mr. Dudley, like Mr. Polk (R. 1433), Mr. Elsey (R. 1285), Mr. Ehrman (R. 1240-42) and the prominent tax specialists who offered to testify on the call of appellees (R. 1586-95),[22] had never heard of any such claim (R. 1063). Mr. Tarleau and Mr. Rapp said the idea had no merit (R. 1062-63). Although the Corporation had no financial interest in the tax negotiations since it would pay no taxes in any event (Ex. D. 46, R. 2040), it had, nevertheless, control over the tax transactions. The returns could not be filed except as they were signed and filed by the Corporation (Treas. Regs. 104, Sec. 23.16). The trustees, who had the financial interest, hired and paid tax counsel (Ex. D. 39-E, R. 1746, 1233), but Mr. Polk gave only advice (R. 1403, 1414, 1415, 1417); he did not make decisions. The final decisions were necessarily made by the Corporation when it filed the returns. In the tax trans-

---

[22]This testimony was excluded as unnecessary and irrelevant (R. 1593) and appellants objected successfully when Mr. Coulson was asked whether he had ever heard of any such claim (R. 1498-1500).

actions the Corporation suffered no abuse; its personnel were competent and informed; its decisions were deliberate and supported by twenty years of past practice.

Incompetence on the part of Corporation personnel would not in any event either relieve the Corporation of its fiduciary duties or impose fiduciary duties on others in the Corporation's favor. A fiduciary cannot avoid his responsibilities by lack of capacity. Nor can he, by complaining of his disability, impose those responsibilities on others. The Corporation as holding company and as a member of the group had fiduciary duties in the tax transactions. Those duties bound the Corporation whoever its officers and directors might be. They were binding, moreover, on anyone who took charge of or participated in the tax transactions. Even if it were the fact, which it is not, that the trustees or their lawyers took charge of tax matters the consequence would be only that the trustees and their lawyers, to the extent they acted for the Corporation, would be obligated to honor the fiduciary duties of the Corporation.

Those fiduciary duties, moreover, are not defined, as appellants seem to believe, by the rules which apply to formal trusts. Fiduciary obligations in connection with corporate affairs are those which are appropriate for that purpose. They are not those which relate to express trusts. *Manufacturers Trust Co. v. Becker*, 338 U.S. 304, 311, 70 S.Ct. 127, 132 (1949).[23] As far as consolidated returns are concerned they are best defined by the past practice of the group and all the precedents, all of which are in accordance with what was done and opposed to what appellants claim should have been done.

---

[23]Compare *Securities and Exchange Commission v. Chenery Corp.*, 318 U.S. 80, 85, 63 S.Ct. 454, 458 (1943): "But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?"

Nothing which occurred in connection with taxes relieved the Corporation of its normal fiduciary duties to its subsidiaries and their creditors. Nothing imposed fiduciary duties on those subsidiaries in favor of the Corporation. The position of the Corporation was in no sense the position of a cestui que trust. There was no trust, no trust res, and no trust obligation running to the Corporation. A discussion of fiduciary duties in this case serves only to support the judgment below. The decisions of the Supreme Court make it clear that a fiduciary obligation ran from the Corporation to the unpaid creditors of its subsidiary. The decision below refusing to permit the Corporation to prefer its interest over the interest of those creditors is in accordance with that obligation.

4. APPELLANTS HAVE NO CLAIM ON ACCOUNT OF DUALITY.

The intervener appellants emphasize that the Corporation officers who handled the tax transaction were also employed by the old company and by the trustees. This duality is of no assistance to appellants. The doctrine even in a general sense has no application here; duality in any event is not a wrong and of itself it creates no rights; and, finally, nothing which was done was in fact unfair to appellants.

(i) The Duality Doctrine Has No Application Here.

First. The Corporation cannot complain of a duality which it created for its own purposes. The dual employment of Western Pacific personnel came about at the direction of the Corporation (this brief p. 3); the trustees assumed the expense of the joint New York office at the Corporation's specific request (this brief p. 6). The Corporation cannot now complain. "* * * when appealing to a court of equity for the enforcement of his rights against others the plaintiff should not himself be responsible for the condition of which he complains." *Myers v. Louisiana*

& A. Ry. Co., 7 F. Supp. 97, 99 (W.D. La. 1934); *Rosaly v. Gonzales,* 106 F.2d 169, 172 (C.C.A. 1, 1939).

Second. Duality between the Corporation and the officers of the reorganization court is of no significance. The pay from the reorganization trustees did not impose an obligation on the officers of the Corporation inconsistent with their obligations to their company. The trustees had no personal interest in the reorganization. *In re Ducker,* 134 Fed. 43 (C.C.A. 6, 1905). Their only purpose was to see that all approved claims were paid. There was, therefore, none of the conflict of interest upon which the duality rule depends. "Here we are dealing with officers of the court and directors appointed by them, men of standing, ability and integrity. There is here no room for any reaction of prejudice or bias, conscious or otherwise, to the frailties of human nature * * *" *J. C. F. Holding Corp. v. General Gas & Electric Corp.,* 46 N.Y. S.2d 605 (1943). Moreover, the Bankruptcy Rules themselves demonstrate that duality in connection with a reorganization proceeding is not a significant circumstance. General Order 44 contains a special provision authorizing the court in a railroad reorganization proceeding to employ attorneys associated with the debtor. Duality does not affect the course or finality of a reorganization proceeding. *Duryee v. Erie R. Co.,* 175 F.2d 58 (C.A. 6, 1949) cert. den. 338 U.S. 861.

Third. The duality cases do not criticize a transaction conducted in accordance with what prudent and independent persons would have done under the circumstances *Hellier v. Baush Machine Tool Co.,* 21 F.2d 705, 707 (C.C.A. 1, 1927); *International Radio Telegraph Co. v. Atlantic Communication Co.,* 290 Fed. 698, 702 (C.C.A. 2, 1923) without benefit of hindsight *Blaustein v. Pan American Petroleum & Transport Co.,* 56 N.E.2d 705, 715 (N.Y. 1944); *Crawford v. Mexican Petroleum Co. of Delaware,* 130 F.2d 359, 362 (C.C.A. 2, 1942). The tax transaction was handled in strict accordance with twenty years of past

practice of the group, with the general practice of the business community and with all the relevant precedents. Presumably, therefore, any prudent person would have done precisely what was done. The courts will not interfere. *Hellier v. Baush Machine Tool Co.,* supra; *International Radio Telegraph Co. v. Atlantic Communication Co.,* supra.

Fourth. Appellants have failed to make a case under the duality doctrine itself. Thus far appellants have no suggestion as to what "fairness" requires. In the cases upon which appellants rely the courts were not thus left without assistance. There was in the record evidence of market value *Geddes v. Anaconda Copper Mining Co.,* 254 U.S. 590, 600-02, 41 S.Ct. 209, 213 (1921); *De Lamar Mines of Montana v. Mackay,* 104 F.2d 271, 275 (C.C.A. 9, 1939) or some other established guide to fairness *Espach v. Nassau & Suffolk Lighting Co.,* 31 N.Y.S. 2d 259, 264-5 (1941), aff'd *sub nom. Chelrob v. Barrett,* 57 N.E.2d 825 (N.Y. 1944) to which the court could turn. Appellants offer nothing. All the past practice and all the precedents are contrary to their position.

Fifth. Duality as such proves nothing. It creates no rights. Its existence does not constitute a wrong. Appellants, having asserted duality, have yet to prove their claim. "It is not mere existence of an opportunity to do wrong that brings the rule into play; it is the unconscionable use of the opportunity * * *." *Comstock v. Group of Institutional Investors,* 335 U.S. 211, 229, 68 S.Ct. 1454, 1463 (1948); *Leavenworth County Commissioners v. Chicago, Rock Island & Pacific Ry. Co.,* 134 U.S. 688, 705, 10 S.Ct. 708, 714 (1890); *Skelly v. Dockweiler,* 75 F. Supp. 11, 14 (S.D. Cal. 1947); *Everett v. Phillips,* 288 N.Y. 227, 236, 43 N.E.2d 18, 22 (1942). Appellants do not prove a claim by an appeal to a general doctrine of "fairness" unsupported by evidence as to what "fairness" requires.

(ii) Appellants Have No Claim Based on a Hypothetical Bargain.

Interveners argue in effect that this Court should make a retrospective bargain between the reorganization trustees and the Corporation and enforce it against appellees (In. Br. p. 49). This asks the impossible.

First. This Court has no power to exercise bankruptcy jurisdiction to make a bargain for appellants. The reorganization trustees are not parties to this proceeding and cannot be made parties. The Court can hardly bargain for them in their absence. Moreover, jurisdiction over those trustees is vested not in this Court but in the bankruptcy court and the jurisdiction is exclusive. *U. S. Fidelity & Guaranty Co. v. Bray,* 225 U.S. 205, 217, 32 S.Ct. 620, 625 (1912); *Isaacs v. Hobbs Tie & T. Co.,* 282 U.S. 734, 739, 51 S.Ct. 270, 272 (1931).

Second. The bargain which the interveners demand would have destroyed the tax saving. Under the Internal Revenue Code a loss on the worthlessness of stock is a tax deduction only if the stock is completely worthless.[24] If a stock otherwise worthless has *any* element of value attached to it, worthlessness is not established and the loss cannot be taken either in whole or in part.[25]

The Corporation's position in the tax transaction resulted solely from the fact that it owned the stock of the old company. Any

---

[24]Treas. Reg. 111, Sec. 29.23(e)-4 (I.R.C.). 5 Mertens, *Law of Federal Income Taxation* (1942) pp. 256-57.

[25]I.T. 3252 [1939—I Cum. Bull. 182] is the Treasury's response to a request for advice on this situation. In 1936, A agreed to buy from the M Company certain stock of the O Company. In 1937, A paid a portion of the purchase price. In that year the stock definitely became worthless. A, however, was obligated to complete payment for the stock. The question was whether the M Company could deduct for tax purposes its loss on account of the worthlessness of the stock. The answer was no: "It is further held that inasmuch as the M Company holds A's contractual obligation to pay to it the sum of 5x Dollars for the stock (being the cost of such stock to the M Company), these particular shares of stock are not worthless in its hands and, therefore, it is not entitled, for Federal income tax purposes, to deduct from its gross income for the year 1937 any part of its investment in such shares of stock."

payment made to the Corporation or any agreement for such payment would itself demonstrate that the stock had an element of value, an element of value measured precisely by the payment. The stock would not, therefore, be totally worthless and the deduction could not be taken. Thus the bargain which interveners say should have been made could not in fact have been made without destroying the "tax saving" upon which appellants rely for judgment.

Third. The reorganization court would have required the Corporation to sign the returns without a "tax saving" payment. The reorganization court had power to compel the Corporation to sign the returns, had it proved recalcitrant.[26] A bankruptcy court has the powers of a court of equity. *S. E. C. v. United States Realty Co.,* 310 U.S. 434, 455, 60 S.Ct. 1044, 1053 (1940). As such, it has full power in a reorganization proceeding to protect the assets of the estate. "The jurisdiction of the bankruptcy court in Chapter X proceedings to protect and preserve the property of the bank-

---

[26]The interveners appear to have dropped the argument that the Corporation is entitled to judgment because it could have levied tribute by refusing to sign the returns. They are well advised. A reorganization court pays nothing for nuisance value. "In these proceedings there is no occasion for the court to yield to such pressures." *Case v. Los Angeles Lumber Co.,* 308 U.S. 106, 129, 60 S.Ct. 1, 14 (1939). Moreover, if appellants had exacted a price for a signature to the consolidated returns they would have been forced to return the tribute thus collected. It is not common practice to require payment for the service of signing a paper and the cases are not numerous. They agree, however, in requiring repayment of the price exacted. See *Kelley v. Caplice,* 23 Kan. 337 (1880), aff'd on rehearing, 27 Kan. 359 (1882); *Guetzkow Bros. Co. v. Breese,* 72 N.W. 45 (Wis. 1897); *Lain v. Rennert,* 32 N.E.2d 375 (Ill. App. 1941); *Oswald v. El Centro,* 211 Cal. 45, 292 Pac. 1073 (1930); *American Bank & Trust Co. v. Federal Reserve Bank,* 256 U.S. 350, 41 S.Ct. 499 (1921); *Rees v. Schmits,* 164 Ill. App. 250 (1911). The contention, moreover, that a hard bargain should have been made with the trustees has no merit in an equity court. "The complaint that its board of directors did not drive a harder bargain, or the hardest bargain, that it might have driven should have no appeal to a court of equity. On the contrary, courts of equity often proceed upon a contrary and opposite theory." *Atwater v. Wheeling & L. E. Ry. Co.,* 56 F.2d 720, 724 (C.C.A. 6, 1932).

rupt estate was not in question and could not be questioned." *Duda v. Sterling Mfg. Co.,* 178 F.2d 428, 434 (C.A. 8, 1949). In the exercise of that jurisdiction the reorganization court would have compelled the Corporation, a party to the reorganization proceeding,[27] to join in the returns and thus to conserve the assets of the bankruptcy estate. As sole stockholder of the old company, the Corporation had general fiduciary duties to its subsidiaries, particularly in the interest of the latter's creditors (*Consolidated Rock Products Co. v. DuBois,* 312 U.S. 510, 522, 61 S.Ct. 675, 683 (1941)) and special duties arising out of the bankruptcy proceeding to conserve the assets for the benefit of creditors.[28] Under such circumstances the reorganization court would never have allowed the Corporation to deplete these assets by demanding payment for signing a paper.

(iii) There Has Been No Unfairness to Appellants.

The duality doctrine, even if it has application here, goes no further than to say that the tax transaction should be fairly conducted. By every available standard there has been no unfairness

---

[27]*Callaway v. Benton,* 336 U.S. 132, 69 S.Ct. 435 (1949), upon which appellants rely, involved the power of the reorganization court over a stranger to the proceeding.

[28]Compare 3 *Collier on Bankruptcy* (14th ed.) Par. 62.30, p. 1573: "Among [the duties of the bankrupt] is the duty to preserve the estate for the benefit of the creditors and to do whatever is needed to protect the assets from deterioration until, either a custodian or a receiver or the trustee has taken charge of them. This duty is not specifically mentioned in the statute, but has been recognized by the courts." See also *In re Hines,* 69 F.2d 52 (C.C.A. 2, 1934); *Sellers v. Bell,* 94 Fed. 801, 809 (C.C.A. 5, 1899); *In re Beck,* 92 Fed. 889, 891 (S.D. Iowa 1899); *In re Connecticut Co.,* 95 F.2d 311, 315 (C.C.A. 2, 1938) cert. den. 304 U.S. 571. The obligations of the debtor are binding upon the stockholders of the debtor. Sec. 77(1) provides in part: "In proceedings under this section * * * the duties * * * of all persons with respect to the debtor and its property, shall be the same as if a voluntary petition for adjudication had been filed * * *." And Sec. 7b of the Act provides in part: "Where the bankrupt is a corporation, * * * its stockholders or members, or such of them as may be designated by the court, shall perform the duties imposed upon the bankrupt by this Act." See, e.g., *Goldie v. Cox,* 130 F.2d 695 (C.C.A. 8, 1942); *In re Songood Realty Co.,* 32 F. Supp. 121 (E.D. N.Y. 1940).

to appellants. What was done was in strict accordance with the past practice of the Western Pacific group, with the generally accepted business practice and with the uniform conclusion of the Securities and Exchange Commission, the Treasury Department, the Federal Trade Commission and all persons who have considered the problem. What better test could there be of "fairness"?

Indeed, if "fairness" is the test, it is appellants who must fail. There is no "fairness" in the effort of the Corporation to repudiate for its selfish purposes the established practice of the group; nor in the demand of the Corporation for a payment from a transaction in which it was neither wronged nor damaged; nor in the attempt of the Corporation to substitute itself as tax collector; nor in the effort of the Corporation to deprive the group of the benefit of a tax deduction allowed by Congress; nor in permitting the Corporation to recover a $17,000,000 judgment against a reorganized company owned by the unpaid creditors of its subsidiary (and their successors in interest) to whom the Corporation owed fiduciary obligations; nor in allowing the Corporation, a party to the reorganization proceeding, to repudiate that proceeding retroactively and assert a claim relating to the reorganization period which was never presented to the reorganization court and which, if allowed, would frustrate the purpose of the reorganization; nor in permitting the Corporation to undermine the financial position of the reorganized company on the basis of an afterthought claim presented too late and in the wrong forum. "Fairness" in this case is with the judgment below.

5. APPELLANTS' AUTHORITIES.

The case on which appellants chiefly rely, *Commercial National Bank in Shreveport v. Connolly*, 176 F.2d 1004 (C.A. 5, 1949) demonstrates the distance by which they fail to support their claim.

The Old Bank, virtually insolvent, conveyed all its assets to the New Bank, which assumed the Old Bank's liabilities to creditors. The contract between the Banks (which proved highly profitable to the New Bank) authorized the New Bank to administer Old Bank assets and collect from them an amount sufficient to indemnify it for the liabilities assumed. The remaining assets were to be reconveyed to the Old Bank or liquidated for the Old Bank's account. The litigation was a suit by the Old Bank for an accounting.

The assets conveyed to the New Bank included certain parcels of real property. The Louisiana statute taxing the capital stock of banks provided that the assessed value of the stock might be reduced by the assessed value of all real property owned by the bank. The New Bank reduced the tax on its capital stock by the value of the Old Bank's real property. The court held, after a prior appeal[29] and over dissent, that in the accounting the Old Bank was entitled to a credit for the tax advantage which came to the New Bank from holding that part of the property which was transferred in pledge rather than by an outright conveyance. The basis of decision was the relation between the parties established by the express agreement of liquidation and pledge. The court said:

> "We are of the opinion, from a construction of the entire contract and the purpose and intent of the parties, that Class C assets were merely pledged—subject to the right of substitution aforementioned—as indemnity or security to the New Bank against loss in the assumption of the liabilities and in payment of expenses, costs, and charges. In such a situation the law of Louisiana seems to be that a relation of trust exists between the New Bank and the Old in reference to said C assets so pledged, and that the New Bank, as such

---

[29]*Commercial National Bank in Shreveport v. Parsons,* 144 F.2d 231 (C.C.A. 5, 1944), rehearing denied, 145 F.2d 191 (1944), cert. den. 323 U.S. 796, 65 S.Ct. 440 (1945). Opinions of the trial court are reported at 28 F. Supp. 927, 44 F. Supp. 5, 64 F. Supp. 888, and 72 F. Supp. 961.

> pledgee or trustee, should use the fruits of the pledge only for the benefit of the pledgor or cestui que trust unless the contract or pledge otherwise provides. Hence it follows that such increments, fruits, or profits as derived from Class C real estate savings made in the capital stock taxes of the New Bank should have been credited to the Class C Assets Account." (176 F.2d 1008)

This case has nothing in common with the *Shreveport* case. The reorganization trustees received no assets from the Corporation in pledge or for purposes of liquidation; they had no express liquidating agreement with the Corporation; they held no trust estate with a duty to account to the Corporation for the proceeds of the trust.

A case more closely in point is *Hopkins v. Detrick,* 97 A.C.A. 55, 217 P.2d 78 (1950) in which a husband claimed a portion of tax refunds payable to the wife on the theory, apparently, that by joining in community property returns he "saved" taxes for the wife. The claim was rejected. See also *Cooper v. Central Alloy Steel Corporation,* 43 Ohio App. 455, 183 N.E. 439, 444 (1931), in which a stockholder's complaint about a "tax saving" arising from a merger was rejected because the complainants "were not interested or concerned" since they were "deprived * * * of not one penny."

The cases cited by appellants which deal with consolidated returns are either plainly irrelevant (see *Woolford Realty Co. v. Rose,* 286 U.S. 319, 52 S.Ct. 568 (1932), holding that losses suffered by a subsidiary in years prior to affiliation cannot be deducted in a consolidated return and *Duke Power Co. v. Commissioner,* 44 F.2d 543 (C.C.A. 4, 1930), holding that a return filed by subsidiaries in which the parent did not join was not acceptable), or they support the traditional formula for intragroup settlements without "tax saving" payments. For instance, in *Helvering v. Morgan's, Inc.,* 293 U.S. 121, 55 S.Ct. 60 (1934), the court recognized the propriety of the early statutory formula appor-

tioning the consolidated tax in accordance with net taxable incomes of the group members. No tax saving payment was made or suggested. In *Koppers Co.,* 8 T.C. 886 (1947), 11 T.C. 894 (1948) the intragroup settlement was again according to the established formula and again there was no intimation that tax saving payments were required—and this even though in the *Koppers* situation there was no "economic unity" within the group. See Moody's Industrial Manual 1941, p. 2598. *Bankers Trust Co. v. Florida East Coast Car Ferry Co.,* 92 F.2d 450 (C.C.A. 5, 1937), is no different. Certain subsidiaries there agreed that a cash refund owing to them for overpayment of taxes should be applied to pay the tax deficiency of another group member. The court recognized that this use of the refund otherwise payable in cash created a right in the contributing subsidiaries to a compensatory payment from the subsidiary whose taxes had been thus paid. Here the Corporation made no tax payment to the Government (R. 1306-07) and it was entitled to no refund. All taxes which were paid were paid by the trustees (R. 824, 826, 1306-07). In the unreported decision *In re Missouri Pacific Railroad Co.,* Docket No. 6935 (E.D. Mo. 1947) a subsidiary by joining in the consolidated returns was faced with an actual cash loss in increased taxes. The group paid the subsidiary not the amount by which the loss benefited the group but rather the amount of actual damage to the subsidiary from the returns. The Corporation in this case had no actual damage and on the theory of this decision it has no claim.

Truncale v. Universal Pictures Co., 76 F. Supp. 465 (S.D. N.Y. 1948) merely illustrates the familiar rule that corporate directors are not allowed to profit at the expense of their corporation. The directors reduced their personal taxes by causing the corporation to forego certain tax deductions. This increased the tax of the corporation. The District Court denied a motion for summary judgment on the ground that the corporation might possibly re-

cover the full amount of the profit to the directors since "Directors and other officers of a private corporation cannot either directly or indirectly * * * in any * * * transaction in which they are under a duty to guard the interests of the corporation make any profit for themselves or acquire any other personal benefit or advantage, * * *" (76 F. Supp. at 468). *Edwards v. Lee's Administrator,* 96 S.W.2d 1028 (Ky. Ct. App. 1936), the Kentucky cave case, involves nothing more than a distribution of profits where the defendants "were guilty of repeated trespasses upon" plaintiff's cave property. "The proof likewise clearly indicates that the trespasses were wilful and not innocent." (96 S.W.2d at 1030).

Chelrob, Inc. v. Barrett, 57 N.E.2d 825 (N.Y. 1944) says only this: that the courts, otherwise reluctant to review business transactions, will, when significant duality appears, make certain that the transactions were fair. The fairness referred to is the fairness which the law requires: a recognition of the rights of the parties. In most cases the extent of those rights requires no discussion. On a sale of property, for example, no one denies that the seller is entitled to a fair price. The problem, as in the *Chelrob* case, is only to determine whether the price was fair.

The decisions cited by appellants in no way support their claims.

6. APPELLANTS HAVE NO SPECIAL CLAIM TO THE 1942 "TAX SAVING."

Appellants apparently believe that the Corporation has a better claim to the 1942 "tax saving" than to the "tax saving" for 1943 and 1944. They rely upon a pre-trial stipulation and order. The settlement of tax liability proposed to the Government provided in form that the returns for 1942, 1943 and 1944 were to be approved as filed and that the claim for refund of 1942 taxes was to be rejected (Ex. P. 7, R. 1658). Interveners applied to the court below for an order restraining the consummation of the settlement on the theory that the rejection of the 1942 refund

claim might be prejudicial to the position of the Corporation in this litigation (R. 346). The parties entered into a stipulation (Ex. P. 7, R. 1658) designed to recognize that the payment of the 1942 tax in the amount of $4,201,821.54 was in substance a settlement of tax liability not for 1942 alone but for 1942, 1943 and the first four months of 1944. The stipulation also provided that for purposes of the litigation the 1942 refund claim, diminished in proportion to the diminution of the entire tax saving, should be deemed to have been allowed and "paid to the plaintiff as the agent for the affiliated group designated in Regulations 104 and 110, and by the plaintiff paid into court" (R. 1659). The pre-trial order confirmed the stipulation (R. 163).

Appellants argue that the court below concluded that it should leave the parties where it found them and that the Corporation is therefore entitled to the assumed avails of the reduced refund claim. This contention was urged upon the District Court in a motion to amend the findings and rejected.

> "Mr. Levy: Your Honor, as I read your opinion, has decided not that we are not entitled to it, not that the defendant is not entitled to it, but rather that the United States government is entitled to it, and as between these two litigants you are going to leave them where you find them.
>
> "The Court: That is not true. I think I also placed the decision on the ground that I couldn't see any reason why the plaintiff would be entitled to it anyhow." (R. 429)

The court, noting that "the plaintiff is only a stakeholder and he doesn't get any greater rights because he is made a stakeholder" (R. 432), made it clear that the effect of the pre-trial order was to protect the position of the Corporation in relation to the reduced refund claim only if it should be found "entitled to it" (R. 428, 429) and denied the motion (R. 453).

The ruling was correct. The 1942 taxes were paid not by the Corporation but by the reorganization trustees (R. 824, 826,

1306-07). The stipulation and pre-trial order gave to the Corporation no better claim to the refund than to the remainder of the "tax savings" of the trustees. When the District Court determined that the Corporation was without a valid claim to any of the "tax savings," the case was disposed of in its entirety.

C. Appellants Have No Claim Based on the Revenue Acts.

The argument that Congress in enacting the revenue acts had some purpose to benefit parent companies in holding company systems is without foundation. There are a number of reasons.

First. The revenue acts create no private rights. They collect revenue to pay the expense of government. *Meriwether v. Garrett,* 102 U.S. 472, 513 (1880). Indeed, if a tax law requires the payment of money from one private person to another, it becomes unconstitutional. *United States v. Butler,* 297 U.S. 1, 61, 56 S.Ct. 312, 317 (1936). Appellants argue for a construction of the revenue acts which would make them invalid.

Second. There is nothing either in the material quoted by appellants or elsewhere in the extensive history of consolidated returns[30] to indicate that Congress intended to confer a special benefit on holding companies. The true purposes of consolidated returns are well understood. They are, first, to facilitate the administration of the tax laws by relieving the Treasury of the burden of reallocating income and deductions on transactions between affiliated companies[31] and, second, to do tax justice be-

---

[30]A tabulation of this material appears in Appendix B, p. 23.

[31]The House Ways and Means Committee reported as follows on the Revenue Act of 1934:

> "Your committee considered at length the question of abolishing the consolidated return. Our subcommittee originally recommended this action. The Treasury believed this policy undesirable. The Treasury pointed out that the one way to secure a correct statement of income from affiliated corporations is to require a consolidated return, with all intercompany transactions eliminated. Otherwise, profits and

tween businesses organized as subsidiaries on one hand and businesses organized by departments on the other.[32] In a business organized by departments the losses of one department offset the income of another. If the same business were organized by subsidiaries this offsetting, without consolidated returns, would not take place. Consolidated returns collect an equal tax from both enterprises. There is nothing here to suggest that Congress has any particular regard for holding companies.

Third. The Corporation cannot recover in this Court by speculating on an intent of Congress as deduced from casual language in committee reports relating to revenue acts. Congressional intent becomes significant in court only when Congress has passed a statute. If Congress had intended that holding companies as such should have the benefit of consolidated returns Congress would have enacted a bill which said so—providing, of course, that somewhere in the Constitution power could be found to support such legislation.

> losses may be shifted from one wholly owned subsidiary to another, and their separate statements of income do not present an accurate picture of the earnings of the group as a whole. * * * The administration of the income tax law is simpler with the consolidated return since it conforms to ordinary business practice; enables the Treasury to deal with a single taxpayer instead of many subsidiaries; and eliminates the necessity of examining the bona fides of thousands of intercompany transactions." H. Rep. No. 704, 73d Cong., 2 Sess, p. 16.

See, also, S. Rep. No. 960, 70th Cong., 1st Sess, pp. 1, 13, 29; Hearings of House Ways and Means Committee on Revenue Revision, 1934, pp. 86, 99; Report of the Joint Committee on Internal Revenue Taxation on the Revenue Act of 1926, p. 63.

[32]See Memorandum the Finance Committee of the Senate on the 1918 Act:

> "Where a corporation does business through subsidiary corporations, such subsidiaries represent in effect merely different departments of one business. It is just as illogical to tax these subsidiaries separately as it would be to levy a separate tax upon the profits earned by different departments of a single corporation." (p. 9)

See, also, Report of Senate Finance Committee on the Revenue Bill of 1928 as quoted in the Hearings before the Senate Finance Committee on the Revenue Act of 1932, p. 24; Senate Report No. 665, 72d Cong., 1st Sess., p. 9.

Fourth. Appellants' argument is founded upon a singularly unsophisticated view of holding company systems. Appellants would have the Court believe that the holding company systems which file consolidated returns are single ownerships. Nothing could be further from the truth. Consolidated returns can be filed if and whenever 95 percent of the voting stock is within the system (I.R.C. Sec. 141(d)). This says nothing about non-voting common, preferred stocks and senior securities such as notes and bonds. Those securities are normally in the hands of the public. No one knows this better than Congress and it is hardly likely that Congress which has in general been hostile to holding companies would intend by consolidated returns to confer an advantage on those holding companies at the expense of their subsidiaries, the operating companies owned in truth by the public.

Fifth. Appellants' argument that the consolidated return system is intended to benefit holding companies is directly in contradiction to the conclusion of a more studious and unbiased witness. The Federal Trade Commission for several years conducted an elaborate investigation of utility holding company systems, out of which came the Public Utility Holding Company Act of 1935. One aspect of utility operation which the Commission reviewed in detail was the use of consolidated returns. The Commission concluded that the purpose of those returns was to benefit not the holding companies but their subsidiaries. The Commission said:[33]

> "The subsidiary companies in a holding company group are entitled to the benefit of any savings to the group due to filing a consolidated income tax return."

---

[33]Summary Report of the Federal Trade Commission to the Senate of the United States pursuant to Senate Resolution No. 83, 70th Cong., 1st Sess., on Economic, Financial and Corporate Phases of Holding and Operating Companies of Electric and Gas Utilities, Part 72-A Sen. Doc. No. 92, 70th Cong., 1st Sess., p. 478. This report is quoted at greater length in Appendix B, p. 2.

Appellees commend to the Court this conclusion of the Federal Trade Commission.

Sixth. Congress, in so far as it has indicated an intention as to who should receive the benefit of "tax savings" from consolidated returns, has indicated that those savings should go to the operating companies of the group. In considering the bill which eventually became the Public Utility Holding Company Act of 1935, the Congressional committee was sharply critical of the practice which appellants now advocate, that is, a practice whereby the parent company takes to itself the benefit of group "tax savings." For example, Senator Wheeler, chairman of the Senate Committee on Interstate Commerce, in speaking of this practice said of the holding companies: "So that, as a matter of fact, they took that $9,000,000, which should have gone either to the Government, or, if it was not necessary to pay it to the Government, *then it should have gone back to the operating company*."[34] (Emphasis supplied.) References to similar comments on appellants' position are noted in the margin.[35] Thus to the extent that Congress has indicated a preference as to who should receive the benefits of "tax savings" from consolidated returns it has taken a position precisely contrary to that for which appellants argue.

One final point should be made as to the law arguments which appellants advance. Those arguments are founded on doctrines of unjust enrichment and duality which have been in the law for many years. Never, however, have these arguments, or an assumed purpose of Congress in connection with consolidated returns, led to the conclusion which appellants argue. On the contrary, every tribunal, every informed person who has considered the problem, has reached the opposite conclusion.

---

[34]Hearings before the Senate Committee on Interstate Commerce, 74th Cong., 1st Sess., on S. 1725, p. 255.

[35]Hearings before the Committee on Interstate and Foreign Commerce, House of Representatives, 74th Cong., 1st Sess. on H.R. 5423, pp. 153, 849, 992, 1061, 1522; Hearings before the Committee on Interstate Commerce, United States Senate, 74th Cong., 1st Sess. on S. 1725, pp. 83, 122, 255, 557.

II. THE DECISION BELOW IS IN ACCORDANCE WITH ALL THE PRECEDENTS, WITH GENERAL BUSINESS PRACTICE AND WITH THE SPECIAL EQUITIES OF THIS CASE.

The decision of the District Court refusing to recognize appellants' claim for a "tax saving" payment is supported by all the precedents, by general business practice and by the special equities of this case.

A. The Decision Below Is in Accordance with General Business Practice.

Since 1918 it has been regular practice for the business community to file consolidated tax returns. From 1928 to 1944, for example, 54,685 such returns, involving more than 176,000 companies, were placed on file.[36] In each of these 50,000 cases the problem of adjusting intra-group rights and liabilities was necessarily presented. The formula which has always been used is the formula which the Western Pacific group has always followed and which appellants seek to repudiate: an allocation of the tax as calculated in the consolidated return to the group members in proportion to their respective taxable incomes and with no "tax saving" payment.

The Securities and Exchange Commission has noted the existence of the settled business practice:

> "We note the customary solution of a somewhat similar problem that arises when a group of companies files a consolidated tax return. In assigning to each constituent its fair share of the consolidated tax paid by the group it is usual to divide the actual tax among the companies who would have had to pay a tax on an individual basis. If one of the included companies operated at a loss, the consoli-

[36]See for 1928-1941, Statistics of Income for 1941, Part 2, p. 293; for 1942, Treasury Press Release No. 44-54, December 31, 1944, p. 16, and No. V-229, February 25, 1946, p. 6; for 1943, Treasury Press Release No. V-229, February 25, 1946, pp. 6 and 10; for 1944, Statistics of Income for 1944, Part 2, Preliminary, pp. 10-11.

dated tax is of course reduced, but *no* part of the 'saving' is ordinarily paid over to the loss company by the other members of the group."

(Release No. 53, Accounting Series, November 16, 1945, 3 C.C.H. Fed. Sec. Law Serv. 2d ed., Par. 72, 071)

Appellees offered at the trial to support this statement by detailed proof of the business practice as revealed by a special survey of the railroads, the utility systems and representative industrial companies. The proof, excluded as irrelevant (R. 1383), would have demonstrated that business systematically does what appellees say should be done and what was done in this case (R. 1387-93).

B. The Decision Below Is in Accordance with All the Precedents.

The precedents on the proper settlement of intragroup liabilities in connection with consolidated returns come from those tribunals and departments of government which are most intimately concerned with holding company systems: the Securities and Exchange Commission, the Treasury Department, the Federal Trade Commission and the Interstate Commerce Commission. Without exception the practice which has been recommended is the practice which was followed in this case. There is no contrary view.

First. The Securities and Exchange Commission has ruled that the proper practice is to allocate pro rata the consolidated tax without "tax saving" payments. Rule U-45(b)(6), adopted for the regulation of public utility systems, forbids intragroup extensions of credit without S.E.C. approval except in certain cases, one of which is:

"(6) A loan or extension of credit or an agreement of indemnity arising out of a consolidated tax return filed by a holding company (or other parent company) and its subsidiaries: *Provided,* That the top company in the group as-

> sumes primary responsibility for the payment of any tax liability involved, subject to the right to contribution from the several members of the group in an amount *not exceeding* as to any company that percentage of the sum of the normal tax, surtax and excess profits tax on a consolidated basis which the sum of the normal tax, surtax and an excess profits tax of such company if paid on a separate return basis is of the aggregate amount of normal, surtax and excess profits taxes of the individual companies based upon separate returns. * * *"[37] (Emphasis supplied.)

Appellants cite and rely upon three instances in which the Commission is said to have permitted deviations from this formula. In Release No. 4444, dated July 28, 1943, "In the Matter of Consolidated Electric Gas Company, The Islands Gas & Electric Company," Islands, a subsidiary in the Consolidated group, had large war losses in Manila, which were available as tax deductions for the group. If, however, Islands reacquired its properties it would be required to pay the tax which the deductions had eliminated (I.R.C. Sec. 127(c)). The group members proposed a special arrangement to protect Islands against this tax if it were later assessed. The Commission agreed. The purpose of the arrangement was to make certain that Islands did not pay more tax by joining in the consolidated return than it would have paid on a separate return basis. This principle is of no value to appellants. The Corporation paid no tax under the consolidated returns (R. 824, 826, 1306-07).

This same purpose to protect a subsidiary from an actual loss through paying extra taxes on account of a consolidated return underlies the ruling of the Commission in Release No. 5535, dated January 3, 1945, "In the Matter of Cities Service Company." There a subsidiary was amortizing the cost of a plant at a

---

[37]For a detailed discussion as to the effect of the Rule by the semi-official National Association of Railroad and Utility Commissioners see Appendix B, p. 14.

special war-time rate which would result in complete amortization in five years. This provided the subsidiary with large deductions from taxable income which were useful to the group in consolidated returns. It also meant that after the five year period the subsidiary would have no amortization deduction. The group members accordingly agreed to compensate the subsidiary for the disadvantage to it arising from the tax procedures adopted.

The basis for decision in Release No. 4806, dated January 3, 1944 "In the Matter of Consolidated Electric & Gas Company" is stated by the Commission as follows:

> "Inasmuch as Consolidated owns 100% of the common stock equity of each of its subsidiaries affected by the proposal, and there do not appear to be impairments in the earned surplus accounts of such subsidiaries, it is, apart from the accounting consequences of the transaction, immaterial whether the proposed payments are made in the manner proposed or the books of the subsidiaries are permitted to reflect the taxes as reduced by the subject savings and corresponding amounts paid to Consolidated by way of dividends."

Since the parent who received the payment was entitled to the money in any event, the Commission saw this case only as an accounting problem and agreed to the proposed arrangement for that reason.[38]

These releases, it will be noted, are not in any way concerned with the *rights* of group members. The Commission did not intimate that the group member receiving the proposed payment had a right to compel it. Appellants, per contra, seek a ruling compelling payment. No such question was before the Commission in the cited cases. Indeed, if the law required "tax saving" payments, Rule U-45(b)(6), which in effect forbids such payments, would be invalid.

---

[38]Subsequent to the releases upon which appellants rely the Commission gave further attention to "tax savings," criticizing appellants' position from the point of view of sound accounting. See Appendix B, p. 7.

Second. The rulings of the Treasury Department assume and provide for a pro rata allocation of the consolidated tax without tax saving payments. The allocation formula adopted by the Western Pacific group appeared in the Revenue Acts of 1921, 1924 and 1926.[39] In 1928 Congress made all members of an affiliated group (except for a few special occasions) responsible for the full amount of the tax[40] and no allocation formula has since appeared in the statute. For special occasions, however, such as allocating consolidated excess profits tax to provide deductions from normal tax net income, the Treasury has designated the customary formula[41] and the Bureau of Internal Revenue has ruled that it is to be used to determine earnings and profits available for dividends.[42]

39Section 240(b) of the Revenue Act of 1921 provided:

> "(b) In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each."

An identical provision appeared in the Revenue Acts of 1924 and 1926.

40See Art. 15(a) in Treas. Regs. 75 (1928), 78 (1932), 89 (1934), 97 (1936), 102 (1938), and Treas. Reg. 104, Sec. 23.15(a) (1942).

41See T.D. 5086, Amendments to Regulations 103 [1941-2 Cum. Bull. 46-7]. The text is in Appendix B, p. 23.

42I.T. 3637, 1944 Cum. Bull. 258, and I.T. 3692, 1944 Cum. Bull. 261. The texts are in Appendix B, pp. 17 and 21. The consolidated return regulations (Treas. Regs. 104 and 110) assume that the tax allocation will be in accordance with the accepted formula. There are no specific provisions since before now it has never been suggested that consolidated returns required any "tax saving" payment. The regulations contain, however, provisions which are plainly inconsistent with appellants' proposal. They require, for example (Treas. Reg. 104, Sec. 23.34(c)), that whenever income of a parent company is offset in a consolidated return by the loss of a subsidiary (which could not have been availed of by the subsidiary in a separate return), the tax basis upon which the parent holds the stock of the subsidiary must be reduced in an amount equal to the loss. Then upon liquidation or sale of the stock of the subsidiary the amount of gain on which the parent must pay tax is increased. This rule was first developed in the decisions. See *Jordahl & Co.*, 35 B.T.A. 1136, 1139 (1937). Plainly neither the courts in adopting this rule nor the Commissioner in formalizing

Third. The Federal Trade Commission has approved the formula which appellees defend and condemned the formula which appellants propose. The Corporation, as parent, proposes that it should receive from the group members a "tax saving" payment equal to the tax which each group member would have paid had it filed a separate return. This practice, as adopted in the 1920's by a few of the more notorious utility systems, was one reason why the Securities and Exchange Commission was created. The Federal Trade Commission conducted an extensive investigation of the utilities prior to the enactment of the Public Utility Holding Company Act and condemned the practice which appellants ask this Court to establish as law:

> "Holding companies are not justified in recording as income the savings from this procedure of handling Federal income-tax payments. *The subsidiary companies in a holding-company group are entitled to the benefit of any savings to the group due to filing a consolidated income-tax return.* Only the amount of Federal income tax paid by a holding company on the basis of a consolidated return should be borne, in proportion to the taxable income, by those companies having taxable income, for which companies a consolidated return was filed. Stated differently, each company in a holding-company group should pay only its pro-rata share of the tax paid for the group." (Emphasis supplied.)[43]

Appellants are asking the Court to adopt a practice which Congress intended that the Securities and Exchange Commission should eliminate in the utility field and which has been eliminated.

---

it in the regulations intended that the one group member should pay another for the tax benefit of its loss. This would require a double payment for the tax benefit: once to the loss company and once to the Government in increased taxes through reduction in the tax basis of the stock.

[43]Summary Report of the Federal Trade Commission to the Senate of the United States pursuant to Senate Resolution No. 83, 70th Cong., 1st Sess., on Economic, Financial and Corporate Phases of Holding and Operating Companies of Electric and Gas Utilities, Part 72-A Sen. Doc. No. 92, 70th Cong., 1st Sess., p. 478. This report is quoted at greater length in Appendix B at p. 2.

Fourth. The Interstate Commerce Commission has refused to recognize "tax saving" claims. There is no formal ruling by the Interstate Commerce Commission on the proper allocation of taxes under consolidated returns, perhaps because, as appellees offered to prove (R. 1387-93), the railroads universally employ the traditional formula. The Commission has had occasion, however, to consider and reject "tax saving" claims. One case involved the segregation of earnings between a reorganization debtor and its leased lines;[44] another involved the computation of benefits awarded to bondholders on an issue of new securities.[45]

These are the rulings now available on the specific question before the Court. They reach a single and unanimous conclusion: that consolidated returns do not create claims for "tax saving" payments.

C. The Decision Below Is in Accordance with the Special Equities of This Case.

Appellants seek to escape the accumulated force of the past practice of the Western Pacific group, the general business practice and all the precedents by arguing that there are special circumstances in this case which require a departure from established procedures. The argument is unsound. The special circumstances of the case provide no reason for abandoning the past practice—on the contrary, they provide special and additional reasons for following that practice.

1. THE CIRCUMSTANCES OF THE CASE REQUIRE THAT THERE SHOULD BE NO "TAX SAVING" PAYMENT TO THE CORPORATION.

The situation of the Western Pacific during 1942 and thereafter provided a number of special reasons for following the

---

[44] *Central of Georgia Railway Co. Reorganization,* 252 I.C.C. 587, 600 (1942).

[45] *St. Louis-San Francisco Railway Co. Reorganization,* 257 I.C.C. 399, 410 (1944).

accepted formula in allocating group liabilities in connection with consolidated returns.

First. The group at the direction of the Corporation had followed the established formula for twenty years (R. 1262, Ex. D. 40). Over the years that formula had produced a total tax saving to the Corporation of $593,976.33 (Ex. D. 46, R. 2040) for which the Corporation had made no tax saving payments to the group members (R. 1262, Ex. D. 40). With the termination of affiliations in sight and an opportunity now available whereby the other group members could benefit from the accepted formula, it would have been grossly unfair to have abandoned that formula simply because some other procedure now became more advantageous to the Corporation.

Second. The creditors of the old company were unpaid and the company was in reorganization. Those creditors holding first mortgage and income bonds (*In re Western Pac. R. Co.,* 34 F. Supp. 493, 497) were, on any analysis, entitled to a preferred position over the Corporation which held only unsecured claims and the stock interest (34 F. Supp. 493, 497). A settlement of the intragroup liabilities in accordance with the past practice gave the benefit of the "tax savings" to those unpaid creditors. A "tax saving" payment, per contra, would have preferred the stock and unsecured interest over the bondholders with their secured position. It would have been a flagrant violation of the duties of a holding company to the creditors of its system.

Third. The "tax saving" was a saving to the reorganization trustees. Those trustees held the railroad properties and the income produced from them for the benefit of the creditors of the bankruptcy estate according to normal ranking—the secured creditors first and the stock interest last. The application of the established formula with no "tax saving" payment to the Corporation left undisturbed the normal ranking; a "tax saving" payment would have reversed that ranking.

Fourth. The Corporation had only a remote possibility, even if affiliation had continued, of receiving any benefit from the "tax saving." Creditors had a prior position which had to be recognized. A "tax saving" payment to the Corporation would have converted that remote possibility into actual cash in hand, a procedure radically unfair to those with a senior position.

Thus it is clear that the special circumstances of the case provided no reasons for a departure from the established practice but, instead, special reasons for following it.

2. THE ALLEGED SEVERANCE OF "ECONOMIC UNITY" AFFORDS NO REASON FOR A SPECIAL CONCLUSION.

Appellants argue that the Supreme Court decision of March 15, 1943 (318 U.S. 448) approving the reorganization plan "severed the economic unity" of the group and thereby created circumstances requiring a special conclusion. This argument has no substance.

First. The Supreme Court decision "severed" nothing. On that date the court approved the Interstate Commerce Commission's plan of reorganization which held worthless the Corporation's interest in the old company. It then became probable (but not certain, see *Insurance Group v. D. & R. G. W. R. Co.*, 329 U.S. 607, 617 n. 6, 67 S.Ct. 583, 587 (1947)) that the reorganization plan would thereafter be confirmed by the District Court, that mechanics would be provided for putting it into operation, and that at some undetermined date in the future the old stock would be cancelled and affiliation would cease to exist. Nothing else then occurred. The stock of the old company remained in the hands of the Corporation. The affiliation continued. Appellants are arguing that the formula used by the Western Pacific group for settling intragroup liabilities for twenty years should have been changed because termination of affiliation was in sight. Why?

Second. The "economic unity" in the Western Pacific group

which, according to appellants, was severed on March 15, 1943, had never existed. From the outset the majority of the first mortgage bonds of the old company were with the public (34 F. Supp. 493, 497). As the financial condition of the old company became more critical, the value of the stock interest disappeared and the company belonged in truth and in equity to its bondholders. *United States v. Butterworth-Judson Corp.*, 269 U.S. 504, 513, 46 S.Ct. 179, 180 (1926); *In re Central Funding Corporation*, 75 F.2d 256, 259 (C.C.A. 2, 1935). There was no "economic unity." It could not, therefore, have been severed on March 15, 1943.

Third. "Economic unity" in matters related to consolidated returns is a false factor demonstrably of no significance. Rarely, if ever, does "economic unity" exist in holding company systems. Only in the exceptional case does the parent company completely own the subsidiaries. More often the parent, by ownership of the voting stock, controls properties which in reality belong to the public through the purchase of senior securities.[46] The revenue acts recognize this diverse economic interest in the ordinary holding company system and they make no requirement of economic unity as a condition for filing consolidated returns. They require only that ninety-five per cent of the voting stock be held within

[46]Summary Report of the Federal Trade Commission on Economic Financial and Corporate Phases of Holding and Operating Companies of Electric and Gas Utilities, Part 72-A, Sen. Doc. No. 92, 70th Cong., 1st Sess. See for example p. 311:

> "On the other hand, the long term debt of the operating companies consists mostly of bonds which are secured by mortgage on their physical properties. The long term debt together with preferred stock usually represent the capital obtained from the investing public. The common stock of the operating companies is usually the voting stock and is owned by the holding companies for control purposes."

See, also, Barnes, *The Economics of Public Utilities Regulation* (1947) p. 73; Bonbright and Means, *The Holding Company* (1932) p. 147; 2 Dewing, *The Financial Policy of Corporations* (4th ed. 1941) p. 1042. Dewing reports that in seven large holding companies, a total of 52% of the bonds, 32% of the preferred stock and 16% of the common stock was publicly held (p. 1051).

the group (I.R.C. Sec. 141).[47] Thus in emphasizing economic unity appellants would have the Court accept the rare situation as the ordinary situation and give significance to a factor to which Congress has attached no significance.

Fourth. The accepted formula for the settlement of intragroup liabilities in connection with consolidated returns makes nothing turn on economic unity. The Securities and Exchange Commission, the Treasury Department, the Federal Trade Commission and the Interstate Commerce Commission are all intimately concerned with holding company groups. The officials of those tribunals are thoroughly familiar with the fact that ordinarily there is no economic unity within the group. They have nevertheless ruled that the intragroup settlement should be made without "tax saving" payments. No exceptions are stated in terms of "economic unity."

Fifth. The assumption by appellants that a holding company in ordinary course receives the benefit of all "tax savings" to its subsidiaries is contrary to fact. Appellants suggest that every benefit to a subsidiary is a benefit to the parent. The Supreme Court has reached a contrary conclusion. "So various are the pos-

---

[47]Since 1918 the Revenue Acts have progressed steadily away from any theory of economic unity or common ownership as far as consolidated returns are concerned. The 1918 statute defined affiliation in general terms of ownership or control (Section 240b). By progressive steps through the Revenue Act of 1924 and the Revenue Act of 1928 the theoretical approach has been abandoned in favor of a technical requirement—ownership of 95% of the voting stock. See 8 Mertens, *Law of Federal Income Taxation* (1942) Sec. 46.13, p. 426.

The cases talk from time to time of a single business enterprise, but whenever it is important they have recognized that the test is what the statute requires and nothing more. See *United States v. Donaldson Realty Co.*, 106 F.2d 509, 517 (C.C.A. 8, 1939); *Commissioner v. General Gas & Electric Corp.*, 72 F.2d 364, 365 (C.C.A. 2, 1934); *Erie Lighting Co. v. Commissioner*, 93 F.2d 883 (C.C.A. 1, 1937). The basic theory of consolidated returns is of course that the returns serve only as a method of computing the tax owing by the individual group members who are and remain the taxpayers. See *Helvering v. Morgan's, Inc.*, 293 U.S. 121, 127, 55 S.Ct. 60, 63 (1934).

sible permutations and combinations of the economic factors that equivalence of surplus or deficit in the accounts of the subsidiary with the gain or loss to the parent would be mere coincidence." *Commissioner v. Phipps,* 336 U.S. 410, 421n, 69 S.Ct. 616, 622 (1949). The Treasury Department agrees: "Moreover, there is no reason for the assumption that the entire earnings of a subsidiary would become dividends to the parent" (Treasury Department release of June 9, 1948, "Consolidated Returns and Intercorporate Dividends," p. 12). If, to take some obvious examples, bonds are in default, debenture interest unpaid, preferred stock in arrears or general creditors unsatisfied, the benefit of any tax reduction on account of consolidated returns never reaches the parent.

In the final analysis the Corporation's position in this case has two elements: that of a holding company and that of a group member whose loss was claimed as a deduction in a consolidated return. The Corporation *as parent* has no right to take to itself the "tax savings" realized by its subsidiaries through the consolidated returns. That abuse of the holding company position has been condemned by Congress (this brief p. 51) and the Federal Trade Commission (this brief p. 50) and eliminated in the utility field by the Securities and Exchange Commission (this brief p. 53). As parent, the Corporation can claim nothing. As a loss company receiving no benefit from the loss, the position of the Corporation is not improved. The entry of a loss in a consolidated return produces no right to compensation in the loss company. This can be demonstrated by the general business practice, the past practice of the Western Pacific group and all the relevant rulings. Subsidiaries normally hold no stock in the parent company or in other group members. They therefore receive no benefit from "tax savings" to the group through their losses. Nevertheless, the subsidiaries never receive "tax saving" payments. If the entry of a loss in a consolidated return entitles

the loss company to compensation because it otherwise has no benefit, virtually every intra group settlement in the past thirty years has been improper and public investors in subsidiary companies have been unlawfully deprived for thirty years of an asset to which they were entitled.

D. The Decision Below Is in Accordance with Sound Policy.

The decision of the District Court refusing to recognize the "tax saving" claim of the Corporation is supported by sound policy. The reasons include:

First. The fact that the Revenue Acts do not create private rights. A tax is an impost levied by the government to obtain revenues to maintain its existence. *Meriwether v. Garrett*, 102 U.S. 472, 513-14 (1880). It creates no private rights. *United States v. Butler*, 297 U.S. 1, 61, 56 S.Ct. 312, 317 (1936).

Second. The fact that "tax saving" payments, if allowed, would contravene the policy against merchandising tax advantages. Transactions which have only a tax purpose are not recognized by the tax law. *Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266 (1935); I. R. C. Sec. 129. "Tax saving" payments, if approved, would provide a new motive for distorting business transactions with relation to the tax law.

Third. The fact that "tax saving" payments, if required, would create great uncertainties in commercial law. Husbands and wives file joint returns (I.R.C. Sec. 51(b)); stockholders to save taxes sell the stock of a business rather than its assets; a lawyer sends a December bill to make a deduction available to his client in the current tax year. Do these ordinary transactions create claims for taxes "saved"?

Fourth. The fact that a requirement of "tax saving" payments would unnecessarily complicate the tax system. Taxation "can never be made simple but we can try to avoid making it needlessly complex." *Dobson v. Commissioner*, 320 U.S. 489,

495, 64 S.Ct. 239, 243 (1943). To impose upon an already complex tax system a complementary system of "tax saving" payments would unnecessarily multiply the complexities of tax administration.

The settled practice against "tax saving" payments should not be disturbed.

III. APPELLANTS' CLAIM IS INEQUITABLE

In this equity proceeding no relief can be granted if the claim presented is without equity. There is no equity in appellants' position.

A. The Corporation Cannot in Equity Repudiate Retroactively the Tax Allocation Formula Followed by the Group for Twenty Years.

Since 1918 the Western Pacific group has filed consolidated tax returns (Ex. D. 40). At the direction of the Corporation the tax under the consolidated return has been allocated to the group members in proportion to net income (R. 1262). There has never been a "tax saving" payment (Ex. D. 40, R. 1262). On many occasions this practice resulted in tax reductions for the Corporation. In each year from 1924 to 1935 the Corporation received a "tax saving" because the loss of another group member was included in consolidated returns (Exs. D. 40, D. 46, R. 2040). The tax thus "saved" totalled $593,976.33 (Ex. D. 46, R. 2040). No payment was made for that saving (R. 1262, Ex. D. 40).

The established formula was followed for each of the years in question. Only long after the event, after the returns were on file, after the reorganization trustees were discharged, after the reorganization proceeding was closed, after it was no longer possible for the trustees to file separate returns and take advantage of deductions unavailable under consolidated returns was this claim asserted. It is, as the court below pointed out, "an after-

thought" (R. 274), a tribute to a lawyer's ingenuity. It has no substance. But if appellants should be successful they will impose upon appellees a total burden of taxes and "tax saving" payments far in excess of the original tax obligation to the Government. This effort to repudiate retroactively the formula which the group had accepted for twenty years cannot commend itself to a court of equity.[48]

B. The Corporation Cannot in Equity Deplete the Assets of Its Former Subsidiary at the Expense of Creditors Who Were Not Paid in Full.

This is a demand for $17,201,739.00 presented against a reorganized railroad by the former parent company. That company directed its former subsidiary to sell securities to the public. The purchasers of those securities are the stockholders (and their successors in interest) of the reorganized company. To these stockholders, as creditors of the old subsidiary, the appellant Corporation owes fiduciary obligations. *Consolidated Rock Products Co. v. Du Bois,* 312 U.S. 510, 522, 61 S.Ct. 675, 683 (1941).

By the plan of reorganization the old bondholders became the present stockholders. The exchange of securities was made on the assumption that the preferred stock of the reorganized company would be worth $100 per share and the common stock $57 per share. *Western Pac. R. Co. Reorganization,* 233 I.C.C. 409, 417 (1939). Even on this basis the secured creditors of the old company were not paid in full. The securities issued to the A. C. James Company, the creditor holding the junior secured position, fell short of paying that company's claim by $3,495,900 (Ex. D.

---

[48]Compare the many estoppel cases in which it has been held that one who participates in an established course of conduct over a long period may not, after the event, attach new consequences to customary activity. See, for example, *Stagg v. Insurance Company,* 10 Wall. 589 (U.S. 1871; *Railroad Company v. United States,* 103 U.S. 703 (1881); *County of Los Angeles c. Cline,* 185 Cal. 299, 197 Pac. 67 (1921).

33, R. 2021). With interest, that unpaid claim now amounts to more than $5,000,000.00.

This $5,000,000.00 does not measure, however, the amount by which the secured creditors were not paid. The securities of the reorganized company have never had the market value assumed by the plan. This Court is entitled to take judicial notice of the fact that during 1949 the preferred ranged in value between $68.50 and $54.50 per share and the common between $22 and $30. *Insurance Group v. D. & R. G. W. R. Co.,* 329 U.S. 607, 617, n. 6, 67 S.Ct. 583, 587 (1947). Thus far in 1950 the range of the preferred has been between $64.50 and $83.50 and of the common between $28.00 and $45.00. The former creditors of the old company, now stockholders of the reorganized company, not only surrendered their first mortgage bonds for securities of an inferior grade (income bonds, preferred stock and common stock) but those inferior securities have never achieved the value which the plan assumed they would have. Appellants now propose to further reduce the assets of these creditors, now stockholders, by $17,201,739.00. Nothing could be more inequitable. Nothing could be more inconsistent with the fiduciary obligation owing from the Corporation to those creditors. Nothing could more plainly violate the settled principle that creditors have an absolute priority over stockholders. *Northern Pacific Ry. v. Boyd,* 228 U.S. 482, 504, 33 S.Ct. 554, 560 (1913); *Case v. Los Angeles Lumber Co.,* 308 U.S. 106, 129, 60 S.Ct. 1, 14 (1939). Nothing could be more radically at odds with the Supreme Court doctrine that the claim of a holding company in the reorganization of its subsidiary must, whatever its technical status, yield to the necessity of doing justice to the creditors of that subsidiary. *Taylor v. Standard Gas Co.,* 306 U.S. 307, 59 S.Ct. 543 (1939).

IV. APPELLANTS' CLAIM IS BARRED BY THE FAILURE TO PRESENT IT DURING THE REORGANIZATION PROCEEDING AND BY THE FINAL ORDERS OF THE REORGANIZATION COURT.

Even if it were assumed that appellants once had a valid claim to a "tax saving" payment, the failure to have it approved by the reorganization court bars recovery.

During 1942, 1943 and the first four months of 1944 the reorganization trustees earned large amounts of income from the railroad properties. That income was subject to tax. The tax liability, if any, was a liability of the trustees, *Reinecke v. Gardner,* 277 U.S. 239, 241, 48 S.Ct. 472, 473 (1928); *415 South Taylor Building Corp.,* 2 T.C. 184, 192 (1943); and the tax, if paid, would have been a cost or expense of administration. *Gardner v. New Jersey,* 329 U.S. 565, 575, 67 S.Ct. 467, 472 (1947); *Goggin v. Bryan,* 172 F.2d 868 (C.A. 9, 1949); *McColgan v. Maier Brewing Co.,* 134 F.2d 385, 387 (C.C.A. 9, 1943). Appellants' claim, based upon an alleged saving of trustee taxes, would, if paid, also have been an expense of administration, that is, an expense of operating the properties during the reorganization period. The question becomes: May appellants, who failed to file claim for payment of an expense of administration in the reorganization proceeding, thereafter, and after the reorganization proceeding is closed, demand payment from the reorganized company? The answer is plainly no.

A. Appellants' Claim Is Contrary to the Policy of Section 77 of the Bankruptcy Act and to the Purpose of the Western Pacific Reorganization.

A defense based upon the bar of a reorganization proceeding is meritorious. It responds to the fundamental purpose of Section 77 of the Bankruptcy Act to rehabilitate the debtor in order that it may discharge its public service functions.

> "Stated briefly, Sec. 77 has for its main purpose 'the rehabilitation of the debtor by a readjustment of its finan-

cial structure in the interest of the debtor and its creditors and security holders, under a fair and equitable plan of reorganization which shall so modify or alter the rights of both secured and unsecured creditors that the fixed charges shall be brought within the probable future earnings available for the payment thereof.' * * * To this end, any reorganization plan should not merely provide immediate relief, but should be drastic enough to assure the continued solvency of the enterprise, even under unfavorable conditions. * * *" 5 *Collier on Bankruptcy* (14th Ed.) Sec. 77.02, pp. 468, 469. (Footnotes and references omitted.)

This public purpose of railroad reorganizations has been emphasized by the Supreme Court. "A basic requirement of any reorganization is the determination of a capitalization which makes it possible not only to respect the priorities of the various classes of claimants but also to give the new company a reasonable prospect for survival." *Group of Inst. Investors v. Chicago, M., St. P. & P. R. Co.,* 318 U.S. 523, 540, 63 S.Ct. 727, 738 (1943); *Ecker v. Western Pac. R. Corp.,* 318 U.S. 448, 474, 63 S.Ct. 692, 708 (1943). If a reorganization proceeding is to be effective in rehabilitating the debtor two things are required:

First. The reorganization court must consider and pass upon all possible claims which might be asserted against the reorganized company. "The very kernel of a reorganization proceeding is the careful consideration given to all outstanding liabilities, debts, and claims. Only in the light of such an examination does it become possible for the bankruptcy court to determine whether the corporation as recapitalized can weather the financial storm." *American Service Co. v. Henderson,* 120 F.2d 525, 529 (C.C.A. , 1941); *Guaranty Trust Company of New York v. Henwood,* 6 F.2d 347, 354 (C.C.A. 8, 1936) cert. den. 300 U.S. 661. To ccomplish this objective of full consideration of all possible liabilities Congress has provided that claims which are not provable n an ordinary bankruptcy can be presented in a reorganiza-

tion *Foust v. Munson SS Lines,* 299 U.S. 77, 82, 57 S.Ct 90, 93 (1936); *American Service Co. v. Henderson,* 120 F.2d 525 (C.C.A. 4, 1941), and this, even though they are "executory or contingent presently due or to mature in the future."[49] *City Bank Co. v. Irving Trust Co.,* 299 U.S. 433, 57 S.Ct. 292 (1937); *Hippodrome Building Co. v. Irving Trust Co.,* 91 F.2d 753, 755 (C.C.A. 2, 1937).

Second. The reorganization must put an end to all outstanding claims. This applies to all reorganizations: to Chapter X proceedings

> "The theory is that there comes a time in the reorganization process when it is in the public interest that litigation should be finally ended. Hence, unless specific provision is made otherwise, the final decree—which concludes the proceeding and closes the estate — discharges and terminates every right against and interest in the debtor of every kind, including liabilities incurred during reorganization, and including even the holders of claims or interests not filed or scheduled in the proceeding or who had no notice of it.
>
> * * * * * * *
>
> "The confirmed plan, as we have seen, binds everyone, and consistent with this, the discharge must terminate all manner of claims or interests, else the reorganized business will be hampered at the outset with holdover obligations which will defeat the very purpose of the proceeding." (6 Collier on Bankruptcy (14th Ed.) Sec. 11.18, pp. 3922-24)

and to railroad reorganizations

> "We are in complete agreement with the observations made by the district court in its opinion dismissing appel-

---

[49]This makes it clear that Corporation could have filed its claim. The 1943 returns which first claimed the stock loss deduction were filed July 15, 1944 (Exs. P. 4A, 4B). The last of the returns were filed June 15, 1945 (Exs. P. 5A, 5B). The reorganization proceeding remained open until March 28, 1946 (Ex. D. 32, R. 2013). Even if it were argued that the claim did not mature until the tax liability was settled, it had in the meantime been "executory or contingent, presently due or to mature in the future" and therefore it should have been filed.

lant's action to the effect that the purpose of the bankruptcy law and the provisions for reorganization could not be realized if the discharge of debtors were not complete and absolute; that if courts should relax the provisions of the law and facilitate the assertion of old claims against discharged and reorganized debtors, the policy of the law would be defeated; that creditors would not participate in reorganizations if they could not feel that the plan was final; and that it would be unjust and unfair to those who had accepted and acted upon a reorganization plan if the court were thereafter to reopen the plan and change the conditions which constituted the basis of its earlier acceptance." *(Duryee v. Erie R. Co.,* 175 F.2d 58, 63 (C.A. 6, 1949) cert. den. 338 U.S. 861.)[50]

Appellants propose to flout these settled purposes of a reorganization. They ask this Court to declare that the reorganized company did not emerge from the reorganization proceeding with its liabilities defined; that on the contrary and in spite of efforts extending over a period of eleven years by the Interstate Commerce Commission, by the court below, by this Court and the Supreme Court, the company emerged from reorganization with an undefined and undisclosed liability of $17,201,739.00, a liability, moreover, to be paid in cash by a reorganized company whose first mortgage bond issue was limited to $10,000,000 and which was permitted to have no other fixed interest charge. This suggestion, if accepted, would render ridiculous the efforts in the reorganization to define the liabilities of the new company. No court has ever intimated that the fundamental purposes of a reorganization could thus be frustrated and defeated.

---

[50]See also: *McColgan v. Maier Brewing Co.,* 134 F.2d 385 (C.C.A. 9, 1943) cert. den. 320 U.S. 737; *Black v. Richfield Oil Corp.,* 146 F.2d 801 (C.C.A. 9, 1944) cert. den. 325 U.S. 867; *In re Colorado & S. R. Co.,* 84 F. Supp. 134 (D.C. Colo. 1949) cert. den. 338 U.S. 847; *Beckley v. Erie R. Co.,* 175 F.2d 64 (C.A. 6, 1949); *Standard Steel Works v. American Pipe & Steel Corp.,* 111 F.2d 1000 (C.C.A. 9, 1940); *North American Car Corp. v. Peerless W. & V. Mach. Corp.,* 143 F.2d 938 (C.C.A. 2, 1944); *In re Peyton Realty Co.,* 148 F.2d 771 (C.C.A. 3, 1945); *Mohonk Realty Corp. v. Wise Shoe Stores,* 111 F.2d 287 (C.C.A. 2, 1940).

B. An Unauthorized and Unapproved Claim for Payment of an Administrative Expense Cannot Be Enforced.

If appellants' claim were a claim against the debtor, it would be barred by the specific provisions of Section 77(f).[51] As a claim for payment of an expense of the reorganization proceeding, it is in no better position.

1. A COURT TRUSTEE CAN INCUR NO LIABILITY WITHOUT COURT APPROVAL AND SECTION 77 AND THE ORDERS IN THE WESTERN PACIFIC REORGANIZATION SO PROVIDE.

The reorganization trustees, as court officers, had no power to incur any liability to appellants for a "tax saving" payment or otherwise except by express authorization of the reorganization court. This is settled. "The receiver being an officer of the court, and acting under the court's direction and instructions, his powers are derived from and defined by the court under which he acts. He is not such a general agent as to have any implied power, and his authority to make expenditures and incur liabilities—like the one in question—must be either found in the order of his appointment, or be approved by the court, before they acquire validity, and have any binding force upon the trust." *Chicago Deposit Vault Co. v. McNulta,* 153 U.S. 554, 561, 14 S.Ct. 915, 918 (1894); *Farmers' Loan & Trust Co. v. Central Railroad Co.,* 7 Fed. 537, 539 (C.C., D. Ia. 1880). The rule is strictly applied. In *Northern Finance Corp. v. Burns,* 5 F.2d 11 (C.C.A. 8, 1925), a receiver without prior authority borrowed funds to pay taxes due from the estate. The claim of the lender for the amount of the

---

[51]Section 77(f) reads in part:

"The property dealt with by the plan, when transferred and conveyed to the debtor or to the other corporation or corporations provided for by the plan, or when retained by the debtor pursuant to the plan, shall be free and clear of all claims of the debtor, its stockholders and creditors, and the debtor shall be discharged from its debts and liabilities, except such as may consistently with the provisions of the plan be reserved in the order confirming the plan or directing such transfer and conveyance or retention, * * *."

loan was denied. In *Byrnes v. Missouri National Bank,* 7 F.2d 978 (C.C.A. 8, 1925), a receiver, authorized to borrow $150,000.00, borrowed an additional $2,000.00. A claim for the $2,000.00 was disallowed. In *In re Erie Lumber Co.,* 150 Fed. 817 (S.D. Ga. 1906), merchants furnished goods to a receiver who had no court authority to buy. They were denied compensation. In *Union Trust Co. v. Illinois Midland Co.,* 117 U.S. 434, 6 S.Ct. 809 (1886), the Supreme Court invalidated a claim for $29,000.00 created by a receiver without prior court approval.

This principle requiring court sanction to create a liability of the estate was approved by Congress for railroad reorganizations. Section 77(e) says that the reorganization plan must provide "*for the payment of all costs of administration and all other allowances made or to be made by the judge.*" And it was expressly recognized in the Western Pacific proceeding. The reorganization court (Ex. D. 20, R. 1908), authorized the debtor to continue its railroad business and provided:

> "The authority given by the foregoing shall not include authority to incur expense, other than such as is necessary in the course of the usual and ordinary maintenance and operation of the debtor's property. *Any extraordinary expense* and expense incident to reorganization of the debtor *shall be subject to the prior approval of the Court.*" (R. 1910) (Emphasis supplied.)

This provision was affirmed in the order appointing the reorganization trustees and transferring the railroad properties to them (Exs. D. 21, D. 22, R. 1916, 1923). An unprecedented liability of $17,201,739.00 is certainly an "extraordinary expense." As such, it could not be incurred without "the prior approval of the Court." No such approval was provided. Accordingly, appellants' claim never became a valid obligation of the trustees or the estate. To obtain strict judicial supervision of all expenses connected with a reorganization was one reason for

substituting Section 77 for the traditional equity receivership. *Leiman v. Guttman,* 336 U.S. 1, 69 S.Ct. 371 (1949). The policy is extremely rigid—so much so that it has been extended to fees and allowances which are not to be paid from the assets of the estate. *Leiman v. Guttman,* supra. Appellants ask this Court to repudiate this firm policy.

2. THIS COURT HAS SPECIFICALLY HELD THAT UNAPPROVED CLAIMS FOR ADMINISTRATIVE EXPENSES CANNOT BE ENFORCED.

In *McColgan v. Maier Brewing Co.,* 134 F.2d 385, 387 (C.C.A. 9, 1943) this Court said:

> "Upon confirmation of the plan for composing the debts of the Maier Brewing Company, the receiver was discharged and the property unconditionally turned back to the corporation. Does the property so returned remain liable for debts incurred by the receiver in the course of administration? We understand not, unless the court has so directed."

In that case properties of the Maier Brewing Company were operated by a bankruptcy receiver from June, 1932, until September, 1938, when, following the approval of a plan of composition, they were returned to the company. In December, 1940, creditors of the company petitioned for a Chapter X reorganization and a trustee was appointed. In the reorganization proceeding the California State Franchise Tax Commissioner filed claims for franchise taxes due for the taxable years 1933 to 1937 inclusive. It was recognized that these taxes were an expense of administration of the earlier receivership but the Court held that since the California Commissioner had not filed a claim in that receivership they could no longer be collected. The Court said:

> "Of course if these taxes had been assessed and a claim made upon the receivers for their payment they would, like administrative expenses generally, have occupied a preferred status. But the statute does not dispense with the necessity for making timely demand for their payment in

the receivership proceeding. As much now as in the past orderly procedure requires that administrative expenses be settled while the property yet remains in the custody of the court." (134 F.2d 388.)

Every consideration which influenced this Court in the *McColgan* case is equally applicable in this proceeding. Here, as there, the orderly administration of the estate requires that claims for administrative expense be filed. Here, as there, the new investors in the new company are entitled to have a precise definition of the liabilities of that company. Here, as there, the persons who participate in the reorganization as creditors or otherwise are entitled to an exact statement of the assets available for the new concern. Compare the recent three-judge court decision in *In re Colorado & S. R. Co.,* 84 F. Supp. 134 (D.C. Colo. 1949) cert. den. 338 U.S. 847, in which it was held that claims of the United States for taxes for periods prior to and during the reorganization were both barred by a failure to present them.[52]

The cases are clear. A claim for payment of an administrative expense must be presented, if it is to be paid, to the court in charge of the administration. Appellants failed to present their claim. It cannot be paid.

3. THE ASSUMPTION AGREEMENT DOES NOT PROVIDE FOR PAYMENT OF APPELLANTS' CLAIMS.

In the fall of 1944 and after the railroad properties had been operated by the trustees for nine years, the reorganization was sufficiently near completion to justify a return of the properties to the reorganized company. On November 27, 1944, the reor-

[52]In the court below appellants relied upon *Texas and Pacific Railway Co. v. Johnson,* 151 U.S. 81, 14 S.Ct. 250 (1894) and *Texas and Pacific Railway Co. v. Bloom,* 164 U.S. 636, 17 S.Ct. 216 (1897), two cases arising out of a single railroad receivership in which it was held that the old company was responsible for the debts of the receiver. The decisions are explained by the fact that the properties were returned without any reorganization taking place.

ganization court directed the revestment effective as of December 31, 1944 (Ex. P. 14, R. 1711, 36-108). It was contemplated, of course, that the trustees would thereafter be discharged. Since all assets of the estate were to be transferred to the new company, some provision had to be made to find funds for the actual payment of the approved and outstanding obligations of the trustees. Under such circumstances it is conventional for the new company to provide the funds required to pay the trustees' recognized debts and the reorganization court directed the execution of an agreement so providing. The language was broad in order to give the trustees full protection against personal liabilities after they had completed their duties and received their discharge.[53] The contention of appellants is that the obligation to make "tax savings" payments was "an obligation incurred by the Trustees in their operation of the debtor's estate and was an obligation assumed by the defendant * * *" (Supp. Compl. par. Eleventh, R. 224). Appellants argued in their trial briefs that the assumption agreement relieved them of the necessity of presenting their claim to the reorganization court. The suggestion is not repeated. In any event, it has no validity. There are many reasons.

First. The purpose of the assumption agreement was to provide money for the discharge of recognized debts and to provide the trustees with personal protection. It was not to undo all the work of the reorganization by giving validity to an undisclosed claim of $17,000,000.00.

Second. The reorganization court, in directing the execution of the assumption agreement, did not eliminate the necessity that expenses of administration be approved by the court. On the contrary it expressly reaffirmed that requirement. Paragraph 10 of the order of November 27, 1944, directing the execution of the assumption agreement, provides in part:

[53]For the text of the assumption agreement see R. 77-78.

"10. The Western Pacific Railroad Company shall pay, *in such amounts as have heretofore been, or shall hereafter be determined by this Court,* but only to the extent that the same shall not have been paid by the debtor's Trustees, *all expenses and costs of administration of this proceeding,* * * *" (Emphasis supplied.) (R. 50.)

Third. Appellants' argument is, in effect, that the reorganized company agreed to assume and discharge *all* obligations of the trustees. The reorganization court made it clear, however, that the assumption agreement should not be so understood. In directing the execution of the agreement the Court described it as follows:

"(a) agreement providing for the assumption of *certain* obligations, liabilities, contracts, agreements and leases of the debtor and the debtor's Trustees, * * *" (R. 46)

and went on to say:

"* * * *and said Railroad Company shall assume only the valid and outstanding obligations and liabilities of the debtor or the debtor's Trustees,* * * *" (Emphasis supplied.) (R. 50)

The references in the order to "*certain* obligations" of the trustees and to "the *valid* and *outstanding* obligations" of the trustees make it clear that it was never intended that the assumption agreement should obligate the reorganized company to pay *all* obligations of the trustees.

Fourth. Since the result of appellants' failure to obtain court approval of their claim is that the claim never became an obligation of the trustees (this brief p. 68), appellants could not recover even if the assumption agreement were construed to refer to all trustee obligations.

Fifth. The reorganization court had no power and it did not intend by the assumption agreement to eliminate the requirement of Section 77(e) that costs of administration be approved by the court.

Sixth. The reorganization court had no power and it did not intend by the assumption agreement to violate the requirement of the plan of reorganization that

> "Claims against the debtor, entitled to priority over any mortgage of the debtor, *current liabilities and obligations incurred by the trustees of the properties of the debtor during the reorganization proceeding,* and expenses of reorganization allowed by the court within the maximum fixed by this Commission shall be paid in cash or assumed by the reorganized company, * * *. The reorganized company shall be deemed to have assumed the executory contracts of the debtor which by their terms do not terminate at or prior to the conclusion of the reorganization proceeding and which shall have been affirmed or shall not have been disaffirmed by the trustees of the properties of the debtor with the approval of the court prior to the confirmation of the plan, *and also any executory contracts made by the trustees of the properties with the approval of the court which by their terms do not terminate at or prior to the conclusion of the reorganization proceeding.*" (Emphasis supplied.)
>
> (Subdivision Q, Western Pacific R. Co. Reorganization, 233 I.C.C. 409, 452-3.)

Appellants' claim if presented to the reorganization court would have been a claim of the right to an executory contract with the trustees for payment of "tax savings." Subdivision Q required specific court approval. The provision for "current liabilities and obligations" refers to obligations which arise in the ordinary course of business and are payable currently.[54] It contemplates

---

[54]In *Lackawanna Iron & Coal Co. v. Farmers' Loan & T. Co.,* 176 U.S. 298, 316, 20 S.Ct. 363, 369 (1900), the Supreme Court distinguished current debts from "extraordinary expenditures outside of the ordinary course of business * * *."

Representative definitions of "current liabilities" are:

Securities and Exchange Commission (Regulation S-X, Rule 3.14):

> "All amounts due and payable within one year shall in general be classed as current liabilities."

Accountant's Weekly Report, Vol. 6, No. 1 (Sept. 29, 1947):

> " 'Current Liabilities' means 'debts or obligations, the liquidation

that such liabilities and obligations would be incurred with the sanction of the reorganization court and in any event it could not refer to an extraordinary claim such as this.

An assumption agreement in a reorganization proceeding has a limited and well understood purpose. It operates within and not beyond the framework of the reorganization. It does not give validity to claims otherwise invalid or give vitality to claims which have been barred.

C. Appellants' Claim Is Barred and Enjoined by the Final Orders of the Reorganization Proceeding.

The revestment order of November 27, 1944 (Ex. P. 14, R. 36), and the final order of March 28, 1946 (Ex. D. 32, R. 2013) each contain provisions of discharge and injunction. Those provisions bar appellants' claim. The revestment order provided (Par. 11, Ex. P. 14, R. 51-52) that the assets of the reorganized company were to be:

> "free and clear of all rights, claims, liens and interests of said Trustees, the former stockholders and creditors of the debtor, and of all other persons * * * except as is otherwise provided in this order, and the said Railroad Company shall thereupon be forever released and discharged from all of its debts, obligations and liabilities, except as herein provided;"

Paragraph 15 of the same order enjoined all persons from:

> "15. * * * in any manner whatsoever disturbing any part of the assets, goods, moneys, railroad, properties and premises belonging to or in the possession of said Railroad Company * * * by reason of or growing out of any obligation or obligations heretofore incurred by the debtor *or the debtor's Trustees herein.*" (R. 59-60) (Emphasis supplied.)

---

or payment of which is reasonably expected to require the use of existing resources properly classifiable as current assets or the creation of other current liabilities."

Thus, the assets of the reorganized company were discharged from and by injunction protected against the assertion of any claim, except as expressly reserved, arising out of an obligation of the trustees. No provision in the order protects and conserves unapproved claims for payment of administrative expenses. On the contrary by paragraph 20 of the order (R. 61-62) the reorganization court expressly reserved jurisdiction to consider and determine the validity of any such claim as appellants now present:

> "* * * and this Court expressly reserves jurisdiction to determine all costs and expenses of administration * * *." (Ex. P. 14, R. 62)

The effect of the revestment order is clear. With certain reservations, it barred all claims against the reorganized company on account of obligations of the trustees, expressly reserving to the court, however, the power to consider and approve claims for payment of expenses of administration.

The reorganization proceeding was not closed until March 28, 1946 (Ex. D. 32, R. 2013), long after all the tax returns in issue here had been filed (Exs. P. 5A, 5B). Appellants never took advantage of the opportunity to present their claim. Accordingly and in due course the court by its final order permanently enjoined the assertion by appellants or anyone else of any such claim as is here presented. Paragraph 6 (Ex. P. 32, R. 2017-18) of that order provides:

> "All persons * * * are hereby perpetually restrained and enjoined from instituting * * * against The Western Pacific Railroad Company * * * directly or indirectly, on account of or based upon any right, claims or interest of any kind or nature whatsoever which any such person, firm or corporation may have had in, to or against the Debtor, or any of its assets or properties, on or before December 28, 1944 (except as specifically provided for or permitted by prior order of this Court), * * * and from interfering with

or taking steps to interfere with said Company, its officers and agents, or the operation of the lines of railroad or properties or the conduct of the business of said Company, by reason or on account of any obligation or obligations incurred by the Debtor or by the Trustees of the Debtor's estate on or before December 28, 1944 (except as specifically provided for or permitted by prior order of this Court), and * * * from prosecuting * * * against the said Company, its agents or attorneys, any suit or proceeding arising out of, or based on, any act or acts done or omitted to be done in putting into effect and carrying out the plan of reorganization or any order of this Court entered in these proceedings."

Appellants' claim is squarely within and in violation of the injunctive provisions of this order. Paragraph 6 protects the reorganized company from claims based upon obligations of either the debtor or the reorganization trustees, except as specifically approved or expressly reserved. This claim is a claim based upon an alleged obligation of the trustees which was neither approved nor reserved.[55] It is therefore enjoined.

The reorganization proceeding is a complete and insurmountable bar to any recovery by appellants in this action. It is a bar because appellants' claim is contrary to the policy of Section 77

---

[55]The reference in the order to December 28, 1944, is of no assistance to appellants. From and after that date the railroad properties were to belong to and be operated by the reorganized company. Thus, by reference to claims "by reason of or on account of any obligation or obligations incurred by the debtor or by the trustees of the debtor's estate on or before December 28, 1944," the court referred to the entire period of trustee operation and plainly intended to foreclose all claims arising out of or in any way connected with that operation. "Tax saving" claims relating to 1942, 1943 and 1944 taxes relate to the period of trustee operation, that is, to the period prior to December 28, 1944. As such they are within the injunctive provisions of Paragraph 6.

Any possibility of doubt as to the intent of the final order is removed by the fact that the District Judge who signed the order subsequently construed it to bar claims arising during the reorganization period. See in the files of this Court *In the matter of The Western Pacific Railroad Company, Debtor,* No. 12159.

and the purpose of the Western Pacific reorganization itself. It is a bar because of the settled rule that a claim for payment of an expense of administration which is not allowed by the court in charge of the estate has no validity. It is a bar because the reorganization court by specific provision has enjoined the assertion of any such claim.[56]

D. The Court Below Was Without Power to Modify Orders of the Reorganization Court.

Appellants have asked in their pleadings (R. 123-154) that, if necessary, there be "a modification of" the final order of the reorganization court "so as to permit the prosecution of" their alleged cause of action (R. 154). There is no power, however, in this Court, or in the District Court sitting in equity, to modify the final order or any other order entered in the reorganization proceeding. Bankruptcy jurisdiction is exclusive. No court other than a court sitting in bankruptcy has jurisdiction to alter,

[56]Appellants' failure to present their "tax saving" claim in the reorganization proceedings also bars the claim under principles of res judicata. A litigant who asserts claims against an estate in the hands of a court must in the first proceeding assert all of his claims or be forever foreclosed. *United States v. California & Ore. Land Co.*, 192 U.S. 355, 24 S.Ct. 266 (1904); *Northern Pacific Railway Co. v. Slaght*, 205 U.S. 122, 27 S.Ct. 442 (1907); *Montezuma Canal v. Smithville Canal*, 218 U.S. 371, 31 S.Ct. 67 (1910); *Estate of Bell*, 153 Cal. 331, 95 Pac. 372 (1908); *Krier v. Krier*, 28 C.2d 841, 172 P.2d 681 (1946).

The claim for 1943 is also barred by the statute of limitations. The 1943 returns took advantage of the loss of the Corporation (Exs. P. 4A, 4B, D. 40). They were filed July 15, 1944 (Exs. P. 4A, 4B). More than two years later, on October 10, 1946, this action was filed (R. 5). California law determines the applicable period of limitation, *Guaranty Trust Co. v. York*, 326 U.S. 99, 65 S.Ct. 1464 (1945), and since this is an unjust enrichment action the two-year statute of Subdivision 1 of Section 339 of the California Code of Civil Procedure is applicable. *Richter v. Henningsan*, 110 Cal. 530, 538, 42 Pac. 1077 (1895); *Bray v. Cohn*, 7 C.A. 124, 93 Pac. 893 (1907); *Trower v. City and County of San Francisco*, 157 Cal. 762, 767, 769, 109 Pac. 617 (1910); *Jacobson v. Mead*, 12 C.A.2d 75, 81, 55 P.2d 285 (1936); *Lazzarevich v. Lazzarevich*, 88 C.A.2d 708, 200 P.2d 49 (1948). This is true even though the action is filed in equity. 16 Cal. Jur. 429, *Williams v. Southern Pacific R. Co.*, 150 Cal. 624, 89 Pac. 599 (1907); *Bell v. Bank of California*, 153 Cal. 234, 94 Pac. 889 (1908).

modify or amend bankruptcy orders. This is settled. *In re Watts and Sachs,* 190 U.S. 1, 27, 23 S.Ct. 718 (1903); *Isaacs v. Hobbs Tie & T. Co.,* 282 U.S. 734, 739, 51 S.Ct. 270, 272 (1931); *Moore v. Scott,* 55 F.2d 863, 864-65 (C.C.A. 9, 1932); *Hanna v. Brictson Mfg. Co.,* 62 F.2d 139, 145 (C.C.A. 8, 1932).

CONCLUSION

It is respectfully submitted that the judgment below should be affirmed with costs to the appellees.

Dated: November 15, 1950.

Allan P. Matthew,
James D. Adams,
Robert L. Lipman,
Burnham Enersen,
Walker Lowry,
McCutchen, Thomas, Matthew,
Griffiths & Greene,
1500 Balfour Building,
San Francisco 4, California
Attorneys for The Western Pacific Railroad Company, et al.,
Appellees;

Everett A. Mathews,
Pillsbury, Madison & Sutro,
225 Bush Street,
San Francisco 4, California
A. Donald Mackinnon,
Milbank, Tweed, Hope & Hadley,
15 Broad Street,
New York 5, New York
Forbes D. Shaw,
Whitman, Ransom, Coulson & Goetz,
40 Wall Street,
New York 5, New York
Attorneys for Western Realty Company,
Appellee.

(Appendices follow)

Appendix A

WESTERN PACIFIC RAILROAD CORPORATION

Schedule of Directors and Terms of Service
1941 to February, 1948

Name	*Period of Service on Board*
T. M. Schumacher	August 1, 1935 until his death on February 26, 1948 (R. 638).
W. W. Kingsley	August 1, 1935 until his death on September 7, 1942.
W. W. Carman	August 1, 1935 to February 1, 1942.
M. J. Curry	August 1, 1935 to present date.
F. J. Shepard	August 1, 1935 until his death on August 22, 1942.
R. E. Coulson	August 1, 1935 to February 6, 1942.
W. D. Wood	August 1, 1935 to present date.
. K. Olyphant, Jr.	January 7, 1937 to December 18, 1941.
A. P. Osborn	January 7, 1937 to present date.
R. M. Price	January 7, 1937 until his death on April 7, 1941.
H. B. Campbell	July 5, 1940 to May 1, 1945.
. F. Wienken	April 29, 1942 to April 25, 1946.
W. W. Hatton	September 23, 1942 to present date.
. C. Sheehan	February 15, 1944 to October 10, 1946.
M. C. Valouch	May 1, 1945 to present date.
F. C. Nicodemus, Jr.	October 10, 1946 to present date.

(Ex. P. 22, R. 1720)

WESTERN PACIFIC RAILROAD CORPORATION

Schedule of Officers and Terms of Service
1935 to February, 1948

Name	*Office*	*Period of Service*
. M. Schumacher	President	August 1, 1935 to Feb. 1, 1942
M. J. Curry	Secretary	August 1, 1935 to Feb. 1, 1942
M. J. Curry	Treasurer	August 1, 1935 to present date
M. J. Curry	President	February 1, 1942 to present date
F. Wienken	Secretary	February 1, 1942 to May 1, 1945
M. C. Valouch	Vice-President and Secretary	May 1, 1945 to present date

(Ex. P. 21, R. 1719)

Appendix B

I. MATERIAL FROM THE FEDERAL TRADE COMMISSION

A. Report of the Federal Trade Commission on Public Utility Holding Companies.[1]

The Public Utility Holding Company Act of 1935 resulted in part from an investigation of the practices of public utility holding companies by the Federal Trade Commission. The report of the Commission reads, in part, as follows:

Income of holding companies due to methods of handling Federal income-tax payments.—Some holding companies have collected from their respective subsidiary companies funds with which to pay Federal income tax for all the companies in a group. The total amount of funds collected by the holding companies from the subsidiaries usually exceeded the amounts actually paid by the holding companies. This practice has resulted in an unusual, if not unjustifiable, means of income to those holding companies engaging in this practice.

During 1923 to 1929, inclusive, The North American Co., from this practice, recorded 1.6 percent of its total income, and Associated Gas & Electric Co. recorded 3.3 percent of its total income. While New England Power Association, in effect, followed this practice, it added the excess amounts so collected to a suspense account and not to income. Cities Service Co. added the amounts collected in following this practice to surplus and related accounts.

Some State commissions engaged in the regulation of gas and electric public-utility companies have permitted operating com-

---

(1) Summary Report of the Federal Trade Commission to the Senate of the United States, pursuant to Senate Resolution No. 83, 70th Cong., 1st Sess., on Economic, Financial and Corporate Phases of Holding and Operating Companies of Electric and Gas Utilities, Part 72-A, Sen. Doc. No. 92, 70th Cong., 1st Sess.

panies to add the estimated amounts of Federal income tax to operating expenses. These estimated amounts are then, in many cases, paid to a holding company, which, in turn, files a consolidated Federal income-tax return. Any saving in tax accomplished through the consolidated return accrues to the gain of the holding company and is retained.

The fact that holding companies retain the difference between the amounts collected from subsidiaries and the amounts paid as income tax indicates that holding companies have not tried to pass on to their subsidiaries the savings which evolve from the corporate structure of holding-company groups. Instead of subsidiary operating companies having this saving, the operating expenses of those companies are inflated by such amounts. The original amounts charged to subsidiary companies were estimated on a basis of what those companies would have had to pay if individual income-tax returns had been made. Inasmuch as the amounts for Federal income tax should never have been added to operating expenses in the first place and were only estimated amounts, anyway, and also, since the amounts were in excess of the Federal income-tax requirements of the group, it would seem that due to this practice there is an inaccurate recording of the true cost of operations of the electric and gas operating companies following this procedure.

In order to emphasize the extent of collections of estimated amounts for Federal income-tax payments from subsidiary companies, by certain holding companies, over the amounts of Federal income tax paid by those holding companies, some illustrations are given.

One illustration of this procedure appears in the report on New England Power Association. During 1928 and 1929 the subsidiary companies paid to New England Power Association, on the basis of individual Federal income-tax returns, $376,971.36 in excess of the amount of Federal income tax paid by the hold-

ing company on the basis of consolidated income-tax returns.

During the years from 1926 to 1929, inclusive, Associated Gas & Electric Co. recorded a gain, due to this procedure of handling Federal income tax, of $2,938,513.12. It is significant to note that Associated Gas & Electric Co. paid no Federal income tax whatever during the years from 1926 to 1929, inclusive, although, of course, Associated Gas & Electric Co. may be subject to assessments in subsequent years for the said period. Also, New England Gas & Electric Association, affiliated with Associated Gas & Electric Co., recorded during 1927 to 1929, inclusive, as income $514,662.99 on the basis of the plan explained above, but no Federal income tax was paid by New England Gas & Electric Association to the United States Government.

An outstanding illustration of this procedure is shown in the report on Cities Service Co. During the years from 1922 to 1930, inclusive, Cities Service Co. collected from its subsidiaries $11,611,601.35 for Federal income taxes. During this period, Cities Service Co. paid Federal income taxes on the basis of a consolidated income-tax return in the sum of $1,745,220.98. The excess amount collected over the amount paid by Cities Service Co. was $9,866,380.37.

As a further illustration, The North American Co. recorded as income $324,915.17 in 1927, $675,000 in 1928, and $275,000 in 1929, or a total of $1,274,915.17 in the 3 years, from handling Federal income-tax payments in the manner previously described.

This Commission considers that there should not be added to operating expenses of electric and gas utility companies any amounts paid as Federal income tax. The amounts paid as Federal income tax should be deducted from the net income on which the tax was calculated.

Holding companies are not justified in recording as income the savings from this procedure of handling Federal income-tax

payments. The subsidiary companies in a holding-company group are entitled to the benefit of any savings to the group due to filing a consolidated income-tax return. Only the amount of Federal income tax paid by a holding company on the basis of a consolidated return should be borne, in proportion to the taxable income, by those companies having taxable income, for which companies a consolidated return was filed. Stated differently, each company in a holding-company group should pay only its pro-rata share of the tax paid for the group. Then no gain from this source would be derived by holding companies.

The pro-rata amount of the total Federal income tax, paid by an operating subsidiary company, should be properly treated on the books of the operating companies. These amounts are not a part of the costs of producing and distributing electric energy or gas (pp. 477-479).

The Commission further stated:[2]

(2) *Direct Statutory Inhibitions*

The more usual and long-established method of legislation which directly and specifically prohibits certain practices, with proper penalties, cannot be overlooked in discussing remedies for the present utility holding company situation. This means that a separate statute should be drawn which makes felonies or misdemeanors of the disclosed abuses so far as they may be reached under Federal jurisdiction. That is to say, it would apply to all utility corporations or their holding companies and affiliates or subsidiaries which are engaged in interstate commerce or which directly affect such commerce. It is believed such legislation can be made to cover situations where a holding company controls in any degree the acts and policies of cor-

(2) Summary Report of the Federal Trade Commission to the Senate of the United States, pursuant to Senate Resolution No. 83, 70th Cong., 1st Sess., on Holding and Operating Companies of Electric and Gas Utilities, Part 73-A, Sen. Doc. No. 92, 70th Cong., 1st Sess.

porations in different States although no one of them operates in more than one State. The privilege of the mails may also be denied as to all matter and transactions intended to promote or carry on the enumerated abuses.

The recommendations immediately following relate primarily to protection of the rate-paying public.

* * * 5. A proper amendment to the Federal income-tax law to prevent collection of anticipated income taxes from operating subsidiaries by holding companies and nonpayment to the Government; also to prevent evasion of such taxes through various forms of so-called "reorganizations", carried on largely within the holding company groups and often primarily for the purpose of such avoidance. In a single instance such avoidance involved a cash profit of over $9,000,000 (pp. 69-70).

II. MATERIAL FROM THE SECURITIES AND EXCHANGE COMMISSION

A. Excerpts from Securities and Exchange Commission Release No. 53, Accounting Series:

For Release in MORNING Newspapers
of Friday, November 16, 1945

SECURITIES AND EXCHANGE COMMISSION
Philadelphia

Securities Act of 1933
Release No. 3100

Securities Exchange Act of 1934
Release No. 3750

Public Utility Holding Company Act of 1935
Release No. 6200

Accounting Series
Release No. 53

IN THE MATTER OF "CHARGES IN LIEU OF TAXES"

* * * * * * *

VI

THE TREATMENT OF "TAX SAVINGS" IN FINANCIAL STATEMENTS FILED WITH THIS COMMISSION

Cases involving the treatment of so-called "tax savings"[23] in

---

(23) We think it undesirable in principle and possibly misleading to efer to this problem as involving "tax savings" although due to the gen- ral use of the term in this sense we have adopted that nomenclature here. t seems to us that the term "tax saving" is apt to connote some sort of tandard or normal tax law and a standard or normal earnings year to vhich that law applies. The facts are, of course, that there has not been static or standard or "normal" tax law or tax status; nor has it been ossible except in most unusual cases to characterize any particular fiscal ear of a company as a "normal earnings" year, from which all others are be regarded as departures. Under such conditions, each year's tax is hatever happens to result from the application of the computation for- nula, provided by the tax law of that year, to the sum total of taxable ransactions and tax deductions resulting from whatever business may have een done in that particular year. Moreover, the past few years during hich the term and the problem of "tax savings" appeared have clearly een unusual in nearly every respect. Finally, if the phenomenon in ques- on is to be described as a "tax saving" it would seem necessary to describe s a "tax loss" the failure to carry through a transaction which it can be id would have resulted in a "tax saving." And if taxes in one year are igher should not that increase itself be considered to be a "tax loss." Our rong preference is to describe the problem as involving "tax reductions."

financial statements have arisen with increasing frequency in recent months. For that reason, as stated earlier, we feel it desirable to state our views as to the treatment to be accorded such items in statements filed with us and to point out the reasons which have led us to those conclusions.

* * * * * * *

We now examine the contention that income taxes should be allocated "as other expenses are allocated." The accountants who appeared before us cited to us no other expense which, for general accounting purposes, is allocated in the manner proposed for income taxes, nor have any such instances otherwise come to our attention. We note, moreover, that in a dissent to the bulletin mentioned earlier it was stated:

> "No expense other than federal income and profits taxes is allocated on the basis of applying to a given transaction so much of the expense as would not have occurred if the transaction to which the expense is attributed had not taken place. The usual method is to allocate a total expense ratably to given accounts or transactions on a consistent basis."

The illustrations of expense allocation cited to us by the certifying accountants in this case appear to us to support the above statement. In each case cited there was an expense actually incurred that was first allocated to the period under the usual accrual principles and then distributed over a number of accounts. In no case was there an estimate made of what the expense would have been under other conditions. In no case cited, was there a distribution of an expense to several accounts by means of what can be termed an algebraic formula in which a negative sum is credited against one item to offset the positive charge to another item of an amount in excess of the actual expense. We do not regard such a treatment as an appropriate means of allocating income taxes in financial statements which

purport to reflect the actual results of operations. We have doubt indeed that such a method can properly be termed an allocation at all, as that term is customarily used.

We note, in passing, moreover, that in the examples of expense allocation cited to us there existed a direct, almost physical association between the item being allocated and the item to which it was charged. For example, in the case of real estate taxes allocated to construction the tax item is directly and closely related to the construction. Likewise, in the case of brokerage fees, and stamp or transfer taxes, the tax item is closely and directly related to the specific transaction. *In both cases, moreover, the tax is independent of any other transactions of the company.* Nor is there any attempt made to increase in the course of the allocation the amount of such taxes to an estimated sum. We feel therefore that such illustrations can not properly be cited in support of the proposed treatment for income taxes.

It is also sometimes pointed out that "cost" in the case of securities or property acquired is generally considered to be the sum of the purchase price plus incidental costs such as brokerage and any specific taxes paid by the buyer and that on sale the proceeds are computed as the selling price less incidental deductions such as commissions or any specific taxes paid by the seller. By analogy and in justification of the proposed treatment of income taxes it is frequently urged that a so-called "tax saving" must be allocated or attributed to or ultimately associated with particular losses or expenses because the tax consequences of the transaction involving the loss or expense were a motivating factor in arriving at the decision to consummate it. Thus, it is claimed that a property would not have been sold but for the "tax saving" thereby effected and that for this reason it is proper to consider that the true "loss" on the sale is not the excess of cost over selling price but is equal instead to the difference

between cost on the one hand and selling price *plus* "tax saving" on the other. We do not believe such an analogy is sound and we cannot accept that analysis as a basis for reporting the results of actual operations. It is undoubtedly true that the tax consequences of selling a property often are an important consideration in arriving at the decision to sell, and may in some cases have been a deciding factor. However, tax consequences undoubtedly play an important role in the making of a great variety of decisions involving the incurrence and amounts of purely operating expenses such as advertising, wage rates and bonus plans. Yet it can hardly be argued that wages or bonuses or advertising are to be reported as less in amount because income taxes would have been higher if the amounts spent on such items were less. We see no basis for adopting a different approach in figuring the "loss" involved in a sale of property. We feel instead that there has been a loss of the full difference between cost and selling price coupled with a tax benefit which is properly reflected in the lower taxes actually paid. We feel that the proposed treatment of income taxes tends to obscure these facts and that the treatment of income taxes required by our rules and heretofore almost universally followed clearly discloses what has taken place. Where the tax paid for the year is unusual in amount because of unusual conditions, an appropriate explanation would be called for as is now required in the case of other unusual events.

As to this last principal contention urged by the certifying accountants (that income taxes are an expense that should be allocated as other expenses are allocated) we feel, first, that there is grave doubt whether income taxes can properly be considered as an expense in the same category as the cost of materials or wages, and, second, that the treatment proposed does not result in the allocation of income taxes "as other

expenses are allocated." We feel instead that the proposed treatment is purely an effort to have items shown in the income statement at what is considered to be a "normal" amount. We note that this objective is clearly expressed as a prime purpose of the method in the bulletin referred to earlier which states at p. 185:

> "As a result of such [unusual] transactions the income tax legally payable may not bear a *normal* relationship to the income shown in the income statement and the accounts therefore may not meet a *normal* standard of significance." (Emphasis supplied)

There are, finally, a number of difficulties involved in the proposed treatment of income taxes that deserve mention even though they are not directly related to the specific contentions put forward by the certifying accountants in the case.

The first involves the preparation of general statistical data from financial reports. Under the method proposed, it is permissible to show, as taxes, an amount in excess of the taxes payable. If such items are totalled for a period of years or for groups of companies, they may well be used as evidence of the aggregate amount of taxes paid by the company or by the industry. Obviously any such representation is erroneous and will misstate, often very materially, the underlying facts. We feel that we should not permit the filing with us of income statements which readily permit, if they do not actually invite, such misuse. Even a "charge in lieu of taxes" may result in distorted overall statistics since it operates to reduce net income after taxes and so affects the ratio of actual taxes to net income. If the offsetting credit is netted against a surplus charge the distortion may be permanent.[35]

---

(35) Under one variant of the practice no change is made in *final net income.* In the statements originally filed in the instant case, for example, part of the amount included as a charge among the operating expenses represented a $609,949 reduction in income taxes due to the taking for tax purposes of accelerated amortization of emergency facilities at the rate of

The second and somewhat technical problem is the difficulty of the computation. It is usual in contemplating the tax consequences of a proposed transaction to treat it as an incremental or marginal item. Where tax rates are graduated, this results in associating the marginal income or expense with the highest tax bracket. It is questionable, whether such a principle is realistic when applied to the results of operations for a completed year. Net taxable income is a composite of all taxable income and all deductible items applicable to the period. The propriety of singling out any specific item as the item which is taxed in the highest tax bracket, is doubtful. Moreover, in applying the theory to losses and expenses it would appear that the existence of a reduction in taxes is due not only to the expense but is equally dependent on the existence of taxable income to offset the expense. It would appear possible that some part of the benefit from the "reduction" ought to be attributed to the existence of income.[36] Even if this point be waived, however, there has

20% a year while in the financial statements only normal depreciation was being accrued. See p. 11 *supra* and Exhibit A. In the original statements this $609,949 was added back as the last item in the account. This internal in-and-out treatment appears to us to suffer from all of the difficulties we have discussed even though no change results in the amount of "net income." In our opinion, an overstatement of operating expenses is not corrected by "adding back" the amount of the overstatement at a later point in the income statement. Such treatment is in our view artificial and deceptive to all but the most experienced reader. While there may be some grounds for crediting such reductions in taxes to a special amortization reserve there is none for the equivocal practice here followed.

(36) We note the customary solution of a somewhat similar problem that arises when a group of companies files a consolidated tax return. In assigning to each constituent its fair share of the consolidated tax paid by the group it is usual to divide the actual tax among the companies who would have had to pay a tax on an individual basis. If one of the included companies operated at a loss, the consolidated tax is of course reduced, but *no* part of the "saving" is ordinarily paid over to the loss company by the other members of the group. Instead, only those *contributing* income to the consolidated return share directly in the benefit of the current reduction. This principle is incorporated in our Rule U-45 under the Public Utility Holding Company Act.

been no satisfactory analysis presented of the effect to be given to the carry-back, carry-forward provisions of the present income tax law. Without exploring all of the possible difficulties, one case may be cited. Suppose that a loss has been charged to surplus but is deductible for taxes. Suppose further that in accordance with the present proposal there is charged to income, as provision for taxes, the amount of $200,000 although the actual tax amounts to only $50,000. If in the next year the company suffers an operating loss of $500,000, then in view of the carry-back provisions the reader of the two income statements would reasonably expect to find a carry-back refund of $200,000—the amount shown as taxes in the first year. However, obviously no more than $50,000 would actually be refundable. The question arises whether having overstated taxes in the first year it is not necessary, to be consistent, to overstate the refund in the second year. Finally, there are the permutations in the computation where a company pays taxes as a member of a consolidated group. In addition to the allocation of the actual tax paid among the several companies in the group, the proposed treatment raises the difficult question of whether the amount of the so-called "saving" is to be computed on the basis of a company's individual status or on that of the consolidated group and, once this is decided, of whether to allocate this "saving" as between the several companies or attribute it solely to the company having the deduction —even though perhaps it itself contributed no taxable income!

The third difficulty is the propriety of singling out the income tax item for adjustment on the ground that it does not bear a "normal" relationship to the income reported. Particularly, under conditions like the present, many if not most of the income and expense items bear unusual relationships to each other. Under the influence of the war sales volumes are often very high. Maintenance may be very high due to continuous operation of the plant, or very low because of the inability to

obtain materials and labor, or very high because of the use of inexperienced labor and the inability to get new machinery, or very low because operations cannot be stopped long enough to make thorough-going maintenance possible. Selling costs may be very low because of the volume of war business or very high because of the use of advertising to keep restricted products in the public's mind. With many items of income and expense apt to be out of line, there appears to be little justification and a good deal of danger in singling out one item for adjustment.

III. MATERIAL FROM THE NATIONAL ASSOCIATION OF RAILROAD AND UTILITIES COMMISSIONERS

A. Excerpts from the 1943 Report of the Committee on Accounts and Satistics of the National Association of Railroad and Utilities Commissioners.

The subject of federal income and excess profits taxes has reached an importance in utility regulation requiring our constant consideration.

It has come to our attention that some utilities are including in the expense accounts for taxes, as a part of the accrual for federal income and excess profits taxes, amounts which they do not pay because of advantage gained by them from certain statutory deductions. We wish to call to your attention the fact that only the amount which it is anticipated will actually be payable for federal income and excess profits taxes can be included in the expenses of a public utility under the systems of accounts now in effect. The so-called "provision in lieu of taxes" may not be entered as an expense of the utility, nor may the amount of taxes which would have been payable, had certain statutory deductions not been available, be recorded as the tax expense.

In view of the importance of such taxes, the Committee has endeavored to prepare a report form that will present to the regulatory commissions such information as it must have for

an adequate understanding of the impact of federal income taxes. Our endeavor is to prepare a form that will not involve substantial additional work and still will provide the necessary information. A draft of such form was prepared by the conferee representing the Michigan Commission (Mr. C. R. Angell) and the said draft has been discussed at our meetings. Such discussion has brought out certain difficulties which it is hoped will soon be overcome. After the said report has been prepared to the satisfaction of the Committee, it will be circulated among all of the member commissions for their attention (pp. 255-56).

B. Excerpts from the 1945 Report of the Committee on Accounts and Statistics of the National Association of Railroad and Utilities Commissioners.

FEDERAL INCOME AND EXCESS PROFITS TAXES

In the 1943 and 1944 reports of the Committee, attention was directed to the problem of accounting for federal income and excess profits taxes by utility companies. Since the beginning of the period of high wartime taxes it has been the practice of many utilities to include in their tax accounts or in unprescribed accounts, such as "charges in lieu of taxes," amounts which do not represent taxes actually payable. Specifically, these amounts represent reductions in taxes otherwise payable except for extraordinary transactions such as a refunding of bonds, losses on sales of non-operating property, and of statutory provisions permitting amortization for tax purposes over a five-year period of certain facilities which qualify under the tax law as emergency facilities. The whole question, however, is complicated by a multiplicity of circumstances whereby there is non-conformity of taxable net income and financial net income reflected by a utility's books of account.

Extensive study also has been given to this question by the staff of the Securities and Exchange Commission, who furnished considerable material to aid the Committee in its consideration

of the question. At the May, 1945 meeting, the Committee culminated its study of the problem by concurrence in the following points:

(1) Income tax expense accounts should be charged with no more than the actual tax liability or a reasonable estimate thereof.

(2) A caption, "charges in lieu of taxes" or similar title should not be used.

(3) When charges to income measured by tax savings are made, they must be made to the proper account for the item to be charged off and must be adequately described.

(4) In assigning income taxes to departments and non-utility operations and transactions, the distribution should be to those departments, etc., which show net profits or income; it is not permissible to assign negative amounts to departments, etc., which show net losses.

An interpretation in accord with the foregoing is included with this report.

*   *   *   *   *   *   *

The Chairman of your Committee canvassed the views of the members and conferees and submitted the question for further discussion at the meeting in May, 1945. On the basis of this interchange of views, the Chairman was authorized to issue the following statement:

* * * For accounting purposes no charge can be permitted in operating expenses except for expenses actually incurred during the period for which the income statement is prepared. Provisions for future expenditures made during a current period must be made by means of an appropriation of net income.

With respect to the rate-making treatment, the following should be observed:

(a) The inclusion as an operating expense of any portion of tax savings, regardless of how they are described or of what they are to cover, is entirely unwarranted. (pp. 458-460)

IV. MATERIAL FROM THE TREASURY DEPARTMENT

A. I.T. 3637 [1944 Cumulative Bulletin 258]:

Section 29.115-3: Earnings or profits.

INTERNAL REVENUE CODE.

> For the purpose of determining the earnings and profits of each member of an affiliated group of corporations for the taxable year 1942 in order to ascertain the amount of earnings and profits of each member of the group which is available for dividends, the consolidated income tax for that year should be apportioned between the members of the group in consonance with the ratio of each corporation's normal-tax net income to the consolidated normal-tax net income, and the consolidated excess profits tax should be apportioned between the members of the group on the basis of the adjusted excess profits net income.

Advice is requested as to the proper method of allocating consolidated income and excess profits taxes for 1942 in the case of an affiliated group of corporations for the purpose of determining the amount of the earnings and profits of each member of the group which is available for dividends.

Authority for the filing of consolidated income and excess profits tax returns for the year 1942 is found in section 141(a) of the Internal Revenue Code, as amended by section 159(a) of the Revenue Act of 1942. Section 141(b) of the Code, as amended, delegates to the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, the right to prescribe such regulations as he may deem necessary "in order that the tax liability of any affiliated group of corporations * * * and of each corporation in the group * * * may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income- and excess-profits-tax liability * * * and in order to prevent avoidance of such tax liability." In so far as they are pertinent to the present inquiry,

Regulations 104, the consolidated income tax regulations, and Regulations 110, the consolidated excess profits tax regulations, are substantially identical.

Section 33.12(a) of Regulations 110 provides that the consolidated return shall be filed by the common parent corporation for the affiliated group. Section 33.12(b) prescribes that each subsidiary must prepare a certain statement consenting to Regulations 110 and authorizing the common parent corporation to make the consolidated return. Section 33.15(a) of Regulations 110 prescribes that "Except as provided in paragraphs (b) [liability of a corporation in bankruptcy or receivership] and (c) [liability of a subsidiary after withdrawal from the group], the common parent corporation and each subsidiary * * * shall be severally liable for the tax * * *." Section 33.16(a) of Regulations 110 reads in part as follows:

> The common parent corporation shall be for all purposes [except where a subsidiary has withdrawn from the group and except where the common parent corporation is dissolved] * * * the sole agent, duly authorized to act in its own name in all matters relating to such tax, for each corporation * * * of the affiliated group. The corporations, other than the common parent, shall not have authority to act for or to represent themselves in any such matter. For example, all correspondence will be carried on directly with the common parent; notices of deficiencies will be mailed only to the common parent * * *; the common parent will file petitions and conduct proceedings before the Board of Tax Appeals [now The Tax Court of the United States] * * *; the common parent will file claims for refund or credit; refunds will be made directly to and in the name of the common parent * * *; and the common parent in its name will give waivers, give bonds, and execute closing agreements * * * and all other documents, and any waiver or bond so given * * * or any other document so executed, shall be considered as having also been given or executed by each such corporation.

For the year 1941, except in the cases of affiliated railroad corporations and Pan-American trade corporations, consolidated returns were not permitted for Federal income tax purposes, such returns being allowed only in connection with the excess profits tax. With respect to the year 1941, section 23(c)(1)(B) of the Internal Revenue Code, prior to its amendment by section 105(c)(1) of the Revenue Act of 1942, permitted the excess profits tax as a deduction in determining normal-tax net income. In this connection, Treasury Decision 5086 (C.B. 1941-2, 38, at page 46), amending Regulations 103 to conform to the Revenue Act of 1941, added section 19.23(c)-4, relating to deductibility of the excess profits tax imposed by Sub-chapter E of Chapter 2 of the Code. Paragraph (d) of section 19.23(c)-4 of Regulations 103, as so added, provides as follows:

> The deduction allowable to a taxpayer which is a member of an affiliated group filing a consolidated excess-profits tax return is an amount which bears the same ratio to the excess-profits tax of the group as the normal-tax net income of the taxpayer, computed without a deduction for excess-profits tax, bears to the sum of the normal-tax net incomes of the several members of the group, computed without a deduction for excess-profits tax.

As shown above, in the case of a consolidated return, each nember of the affiliated group is severally liable for both the ncome tax and the excess profits tax. It has also been shown hat all tax matters are handled solely by the common parent orporation. That is for administrative reasons; each legal entity s still preserved. It was stated in Senate Report No. 960, Seventieth Congress, first session (C.B. 1939-1 (Part 2), 409, at pages 418, 419), in connection with the revenue bill of 1928:

> The advisory committee of the Joint Committee on Internal Revenue Taxation, the members of which worked most of the summer in preparing suggestions for the simplification of the revenue laws and their administration, reached

> the conclusion that, because of the difficulties encountered in administration, there should be a substitute for the consolidated returns provision. It should be emphasized that this conclusion was reached, not upon the ground that consolidated returns were unsound, that additional revenues would be received by the elimination of the consolidated returns provision, but solely upon the ground that the administration of the law would be simplified.
>
> * * * * * * *
>
> The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise.
>
> * * * * * * *
>
> * * * The committee believes it to be impracticable to attempt by legislation to prescribe the various detailed and complicated rules necessary to meet the many differing and complicated situations. Accordingly, it has found it necessary to delegate power to the Commissioner to prescribe regulations legislative in character covering them.

The Bureau is not concerned with arrangements made between affiliated companies as to the payment of the tax. The regulations look to payment being made by the parent corporation only, as such corporation is the only member of the group which can transact negotiations with respect to the tax. As a matter of fact, one of the affiliates may make all of the tax payment via the parent corporation, but if there is an overpayment, the refund is made to the parent corporation. (See section 33.16(a), Regulations 110, supra.)

In determining the amount of earnings and profits of each member of the affiliated group which is available for dividend purposes, it is necessary that each company's earnings be separately ascertained. One of the factors in determining earnings and profits for any taxable year is the amount of income and excess profits taxes due for such year. In a consolidated return

case, the consolidated taxes should be allocated, as set forth below, to each member of the affiliated group. The fact that the parent corporation pays all of the tax should not militate against such an allocation. As heretofore indicated, such tax is paid by the parent as agent for the subsidiaries.

Accordingly, it is held that for the purpose of determining the earnings and profits of each member of an affiliated group of corporations for the taxable year 1942 in order to ascertain the amount of earnings and profits of each member of the group which is available for dividends, the consolidated income tax for that year should be apportioned between the members of the group in consonance with the ratio of each corporation's normal-tax net income to the consolidated normal-tax net income. The consolidated excess profits tax should be apportioned between the members of the group on the basis of the adjusted excess profits net income.

B. I.T. 3692 [1944 Cumulative Bulletin 261]:

Section 29.115-3; Earnings or profits.

INTERNAL REVENUE CODE.

> Method of determining the earnings and profits of each member of an affiliated group of corporations filing consolidated Federal income and excess profits tax returns for 1942 and subsequent taxable years, in order to ascertain the amount of earnings and profits of each member of the group which is available for dividends.
>
> I.T. 3637 (page 258, this Bulletin) amplified.

Request is made for an amplification of I.T. 3637 (page 258, this Bulletin), relating to the method of determining the earnings and profits of each member of an affiliated group of corporations filing consolidated Federal income and excess profits tax returns for the taxable year 1942 in order to ascertain the amount of earnings and profits of each member of the group which is available for dividends.

For the purpose of determining the earnings and profits of each member of an affiliated group of corporations for the taxable year 1942 and subsequent years in order to ascertain the amount of earnings and profits of each member of the group which is available for dividends, the consolidated income tax (line 41, page 1, Form 1120) should be apportioned between the members of the group in accordance with the ratio of that portion of the consolidated normal-tax net income attributable to each member of the affiliated group to the consolidated normal-tax net income (line 40, page 1, Form 1120), leaving out of consideration any member of the group having no net income. The consolidated excess profits tax (line 18(c), page 1, Form 1121) should be apportioned between the members of the group in accordance with the ratio of that portion of the consolidated adjusted excess profits net income attributable to each member of the affiliated group to the consolidated adjusted excess profits net income (line 8, page 1, Form 1121), leaving out of consideration any member of the group having no net income. The taxes thus determined should be (a) decreased by the amount of the consolidated credit for debt retirement (line 21, page 1, Form 1121) attributable to each company; (b) increased or decreased, as the case may be, by the amount of any section 734 adjustment (line 23, page 1, Form 1121) attributable to each company; and (c) decreased by the amount of the consolidated credit for foreign taxes attributable to each company (line 19, page 1, Form 1121). In the event that the income taxes paid to a foreign country or United States possession are in excess of the amounts allowed as credits, the excess should be taken into consideration in arriving at the earnings available for dividends.

C. Excerpt from T.D. 5086, Amendments to Regulations 103 [1941-2 Cumulative Bulletin 46]:

PAR. 21. There is inserted immediately after section 19.23(c)-3 the following:

SEC. 19.23(c)-4. *Excess-profits tax under Subchapter E of Chapter 2 of the Internal Revenue Code.*—The deductibility of the excess-profits tax imposed by Subchapter E of Chapter 2 of the Internal Revenue Code is subject to the following special rules:

* * * * * * *

(d) The deduction allowable to a taxpayer which is a member of an affiliated group filing a consolidated excess-profits tax return is an amount which bears the same ratio to the excess-profits tax of the group as the normal-tax net income of the taxpayer, computed without a deduction for excess-profits tax, bears to the sum of the normal-tax net incomes of the several members of the group, computed without a deduction for excess-profits tax.

V. Tabulation of Congressional Material Relating to Consolidated Tax Returns.

Senate Finance Committee Reports on the Revenue Bills of 1918, 1921, 1928, 1932 and 1934.

House Ways and Means Committee Reports on the Revenue Bills of 1921, 1928 and 1934.

Memorandum of the Senate Finance Committee on the 1918 Revenue Act.

Report of the Joint Committee on Internal Revenue Taxation (1926).

Hearings before the Senate Finance Committee on the Revenue Act of 1928.

Preliminary Report of Sub-Committee of the House Ways and Means Committee on Prevention of Tax Avoidance (1933).

Hearings before the House Ways and Means Committee on the Revenue Revision of 1934.

Hearings before the Senate Finance Committee on the Revenue Act of 1934.

Joint Hearings of the House Ways and Means Committee and the Senate Finance Committee on Excess Profits Taxation (1940).

Hearings before the Senate Finance Committee on the Revenue Act of 1940.

Hearings before the House Ways and Means Committee on Revenue Revision of 1942.